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SUSTAINABLE DEVELOPMENT

The effect of the internalization of external costs on sustainable development

Report by the UNCTAD secretariat

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I. BACKGROUND

1. At the second part of its thirty-ninth session, the Trade and Development Board adopted decision 402 (XXXIX) in which it decided to consider a "theme or themes on sustainable development at the second part of its annual sessions".[1] At the first part of its fortieth session, the Board decided to consider at the second part of its fortieth session, as agenda item 4, the theme: "Sustainable development: the effect of internalization of external costs on sustainable development".

2. The purpose of this decision is to pursue the Board's follow-up to UNCED and to make a contribution to the intergovernmental consideration of this critical area, in which very little work has yet been done. Economists generally argue that the internalization of external environmental costs is a necessary step towards sustainable development. Methods for so doing, particularly when internationally traded products are involved, are still in the early stages of development and have not yet been widely tested. This topic is therefore at the cutting edge of research and debate in the intergovernmental community, and presents UNCTAD with both an opportunity and a challenge. This report is intended to present the issues involved and suggest possible directions for future consideration of these issues in UNCTAD.[2]

3. The phrase "internalization of external costs" is drawn from Principle 16 of the Rio Declaration adopted by the United Nations Conference on Environment and Development in Rio de Janeiro on 14 June 1992.[3] In assessing, as required, its impact on sustainable development, the present report examines the internalization of external costs in the context in which Principle 16 sets it, which requires focusing on economic instruments, on the approach that the polluter should in principle bear the cost of pollution, on avoiding distortion to international trade and investment, and above all on promoting the public interest. Moreover, this report will strive as far as possible to anchor its arguments in the Rio Declaration.

4. By definition, an externality is an effect of one firm's or individual's actions on other firms or individuals who are not parties to those actions. The effect can be negative or positive and create an uncompensated cost or a benefit, respectively, to non-parties.[4] The issue posed by the Board concerns the internalization of external costs only, not external benefits. This report therefore refrains from discussing positive externalities like the services to the world community rendered by reservoirs of biological diversity or by forests as carbon sinks, except in so far as external economies are an inseparable mirror image of external costs. The issue of adequate compensation for the provision of environmental "goods" is, however, of as great importance as that of finding ways to avoid the generation of environmental "bads", and is therefore worthy, in the secretariat's view, of examination in UNCTAD at some future time.

5. It should moreover be noted at the outset that internalization is but a means, the objective being to avoid external costs. An important argument for internalizing external costs is precisely to provide the agent responsible for causing the cost with an incentive to reduce or eliminate it. Avoidance can, however, sometimes be achieved without internalization, for example by taking preventive action, or by eschewing dangerous activity. This set of policy options, though of obvious practical importance, is not treated in the report because of the limited mandate given to the secretariat for the present session of the Board.

II. INTRODUCTION

6. This report takes as its basis the definition of sustainable development

given in the Brundtland Report[5]:

> Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs. It contains within it two key concepts:
>
> - the concept of 'needs', in particular the essential needs of the world's poor, to which overriding priority should be given; and
> - the idea of limitations imposed by the state of technology and social organisation on the environment's ability to meet present and future needs.

Sustainable development is thus intended to direct economic activity towards the satisfaction of present economic and social needs, without thereby jeopardising the bases for future need satisfaction. The emphasis on needs places equity at the centre of the concept of sustainable development, just as the emphasis on keeping options open for future generations requires focus on the wise stewardship of the earth's resource base for future economic activity, of which one aspect is the conservation and management of environmental assets traditionally regarded as free goods. Concern for the future also requires a continuing assessment of the balance between present and future needs and options.

7. From an analytical perspective equity, whether intra- or inter-generational, involves considerations of distribution with which by its nature the market cannot deal: even a perfect market will allocate resources efficiently only from the perspective of the given initial distribution of those resources. It is a matter for the community in question to consider whether that initial distribution is satisfactory and if it decides that it is not, to adjust it according to agreed principles. The present report is not the place to discuss this fundamental issue, which was omnipresent at Rio and led to the adoption of the Rio Principles to which this report refers. In particular, Principle 3 of the Rio Declaration[6] refers to inter-generational equity, and Principle 5[7] to intra-generational equity considerations. In this connexion, reference should also be made to work undertaken by the UNCTAD secretariat with the support of the Government of the Netherlands on what might be called "fair principles" for sustainable development.[8]

8. Because sustainable development is a development concept, it requires economic growth in places where essential needs are not being met. Sustainable development thus gives priority to the urgent present needs of the poor, seeking to do away with poverty, not just pollution. This creates a tension between the rich and the poor which is encapsulated in a single measure of what is needed to achieve sustainability: population times per capita resource consumption. Given the existing distribution of incomes in the developing countries, as modest a development goal as merely to double the real income of the bottom quintile (20%) of the population would require fully 70 years if per capita income in the developing countries grew at but 1% per annum. However, at a 3% rate of growth, such a doubling would require "only" 25 years.[9] Governments in the developing countries are unlikely to aspire to less than this nor would ethical considerations countenance less. Given the expected rate of growth of population, to meet these minimum aspirations would thus require growth rates in aggregate national developing country income on the order of 5.5%, implying that economic activity in the world as a whole would have to rise by at least 5-fold over the next 50 years.[10]

9. Such an immense increase from a level already judged by many observers to be straining existing ecological capacities would seem likely to imperil the long-term security of the planet's ecological base. The challenge for the developed countries is thus to restore an already degraded environment while maintaining, as much as possible, lifestyles (but not necessarily particular modes of consumption) and productive activities (but not necessarily particular products or production processes). For developing countries, the no less daunting

challenge is to eradicate poverty and increase employment and production whilst preserving and protecting the environment. In addition, concerted international action will need to be undertaken in order to address intra-generational equity considerations of a domestic and of an international nature, of which the appropriate sharing of the costs and benefits of sustainability constitutes one of the main components.

10. "Wise stewardship of the earth's resource base" requires a focus on public (i.e., non-excludable) or open access (i.e., potentially excludable) goods[11] such as clean air, clean water, biodiversity, etc.. For too long, these assets have been treated as free goods in the economic production process and consequently over sed in production activities, depleting these resources and generating external environmental costs.[12] Abstracting from the distributional considerations raised earlier, if policies and markets were perfect, as in the textbook models, these external costs would be internalized, as would the external costs associated with the fact that many resources are unowned or unpriced, whilst others are priced too low or their depletion subsidised. It is the "dissociation between scarcity and price, benefits and costs, rights and responsibilities, and actions and consequences" which needs to be addressed if sustainable development is to be assured.[13] These are issues of policy, many of the problems arising from policy-induced distortions (known commonly in the economics literature as "policy failures"). The correction of such distortions (or "failures") constitutes the essence of the internalization issue with which the present document deals in the following chapters.

11. As for all policy measures, those relating to the environment are developed in the context of the tendency of political opinion to concentrate on only a restricted set of issues at any one time. Narrowly focussed action can result in shifting external costs rather than internalizing them.[14] There is a broad similarity here with the theory of the second best in economics, which states that if it is not possible to meet every single condition of competitive equilibrium, to strive to meet the remaining conditions may result in a worse state of affairs than departing from those remaining conditions. The parallel is that to internalize only a particular external cost may result in aggravating the total burden of external environmental costs or in shifting the burden from one social group to another or from one country to another. This does not imply that no action should be taken unless all costs have been internalized; rather, it means that efforts need to be made to establish a policy context in which environmental costs, rather than being externalised or shifted onto others, will instead be reduced or avoided altogether. Internalization measures, considered in chapter III below, can be a step in this direction if applied in the context of a comprehensive environmental policy.

12. To answer the question of the impact of internalization of external costs on sustainable development, it is first necessary to consider the various devices which might be used for such internalization, since the impact is likely to be different from instrument to instrument. The secretariat's modest purpose in the present report is to take the first step in this analysis by examining what instruments are available for internalization, and what are their characteristics. The problem of internalization is an extremely complex one, not only in terms of the identification of instruments to be used for its implementation, but also as regards the implications of such use at the international level and the need for strong internationally concerted action in this respect.

13. The regulatory (or "command and control") approach - in which the government sets environmental standards and designs regulations to ensure they are honoured[15] - has been the primary approach to environmental problems in most countries. Since there is a substantial literature on this approach, the secretariat has preferred in this paper to focus on a range of other instruments which can be used for the internalization of external environmental costs. Chapter III below first looks at the basic principles underlying internalization, focussing in particular on the issue of full cost resource pricing, with which

UNCTAD is particularly well placed to deal. It then addresses the nature of the various instruments for internalization at governments' disposal and their advantages or disadvantages. The chapter further deals, although in a very preliminary way, with a possible scenario for achieving the right "dosage" or policy mix of existing internalization instruments.

Box 1.

Types of external environmental costs

Global public good/open access external environmental costs

Global effects occur when an externality affects every inhabitant of the earth or has worldwide effects. The classic case is the emission of CFCs causing ozone depletion and affecting all humanity, or the use of fossil fuels and the destruction and non-replacement of forest cover causing atmospheric carbon dioxide concentrations to increase, thus threatening global climate change through the "Greenhouse Effect". In the same way, and since ocean fishing is available to all nations, open access over-fishing also constitutes a major global environmental externality.

Although the above-mentioned cases relate to present environmental effects, intertemporal external environmental costs are not only possible but likely since the benefits of decision-making today may accrue largely to the present generation while the costs accrue to future generations, whose costs are given less weight than those of the present generation. As an illustration, the latest estimates on global warming suggest that the global mean temperature will rise by approximately 0.3°C per decade. Unless stopped, this rise will have profound effects on future generations.

Transnational public good/open access external environmental costs

Transboundary external environmental costs occur when their impact seeps over from one country to another. An example is sulphur dioxide emissions from UK coal burning power stations causing acid rain in Scandinavia. The same is true with river water, when a river passes through several nations. As far as intertemporal considerations are concerned, here again, environmental costs such as the loss of amenity to future generations may not be sufficiently accounted for, even if international mechanisms limiting these emissions are established.

Local public good/open access external environmental costs

Air pollution in a city with little effects on other regions of the country, local pollution effects of inappropriate application of pesticides, over-use of forests due to ill-defined property rights and over-grazing due to ill-defined grazing rights, are all illustrations of local public good/open access external environmental costs. Over-grazing by cattle has been a severe problem in Botswana where much of the land is held in common. In many parts of the country, particularly the East, cattle stocking rates are well above the carrying capacity of the land. The intertemporal dimension of the problem is illustrated, for example, in cases of forests, timber or land clearance where the rate of extraction may be higher than justifiable, as the local area of forests left may be insufficient for the purposes of future generations in that area.

14. Finally, the international dimension of internalization, in particular in the presence of transborder and global external environmental costs, is addressed in chapter IV. The advantage of cooperative solutions is noted, and the search for existing or potential mechanisms aiming at achieving internalization, such as marketable permits and commodity-related environmental agreements, and their implications at the international level, are discussed. The essential role of trade as a vehicle for internalization, as well as, in this respect, the great potential of incentives for environmentally sound technology switching, are also examined. The secretariat's conclusions from the analysis are presented in chapter V, together with some suggestions for future work.

III. INTERNALIZING EXTERNAL ENVIRONMENTAL COSTS

A. The basic principles

15. A degree of international agreement has been reached on the basic principles according to which external environmental costs should be internalized. These principles were originally formulated in the OECD countries, but they have achieved global acceptance in the form in which they are reflected in the Rio Declaration, in Principles 7, 10, 15 and 16. The OECD has done most work on the "Polluter Pays Principle" (Principle 16 of the Rio Declaration), work supported by growing experience in application and by a body of literature evaluating that experience.

1. *The Polluter Pays Principle*

16. Principle 16 of the Rio Declaration states that the polluter should, in principle, bear the cost of pollution, with due regard to the public interest and without distorting international trade and investment. This raises the question of who is the polluter: is it the producer of the pollution or the consumer of the good or service who, through his or her demand, induced the producer to pollute? The OECD answer is : "from the point of view of conformity with the Polluter-Pays Principle (PPP), it does not matter whether the polluter passes on to his prices some or all of the environment costs or absorbs them".[16] It does however matter in terms of distributional effects: the more inelastic the demand for a product, the more an increase in cost can be passed on to the buyer; conversely, the more elastic the demand, the more the producer will have to absorb increased costs.

2. *The Resource Pricing Principle*

17. The PPP self-evidently focuses on pollution, whereas sustainable development goes beyond pollution to centre on equity, between generations but above all between rich and poor, its focus on the environment coming in the broader context of the proper use of resources. The failure properly to value scarce resources is the source of incorrect signals sent to decision-makers conveying, in turn, misleading information about resource scarcity and thus providing inadequate incentives for the management, efficient utilization and enhancement of natural resources. If these resources, which include among them all environmental resources, are to be allocated efficiently both in the present and in the future to those uses most effective in stimulating sustainable development, it is necessary that their prices should reflect the full range of the costs involved in using them, including the costs of the external effects associated with exploiting, transforming and using the resources, together with the costs of future uses forgone. This is what can be called the principle of full cost Resource Pricing (RP), which rests on the proposition that the beneficiary of the services rendered by a resource should meet the costs of providing them. If this principle is properly applied, prices will reflect the environmental costs to the community of satisfying marginal demands. Environmentally sound full cost resource pricing should include three sorts of cost:

(a) Firstly, it should include the various capital and operating costs, i.e. the direct costs of production. Subsidies are thus ruled out, as they amount to costs which the beneficiary externalises, and require payments by those who do not benefit from the use of the resource to those who do. More generally, whenever a beneficiary can obtain a good or service at less than its social opportunity cost, the principle of full cost RP is not respected, and adjustments need to be made.

(b) Secondly, full cost RP should include damage control costs, i.e., the costs of pollution prevention and control.

(c) Thirdly, it should also include 'user costs', a particular kind of intergenerational externality defined as any costs that the present use of the resource imposes on future users. With respect to exhaustible resources, user cost for any future period is the difference between the costs that users now face and those they would have faced had the resource not previously been used. More generally, it is the reduction in the value of a resource caused by using it as compared with not using it.

18. In practice, this full cost Resource Pricing principle seems to be very little applied, although its use would clearly be of great importance in avoiding the generation of external environmental costs. Thus, governments intervene in agricultural commodity markets through price support, agricultural taxation, export taxes and macroeconomic interventions. Whilst in the developed countries intervention usually seeks to keep domestic agricultural prices above world market levels,[17] in the developing countries, agricultural production is often influenced by interventions (including marketing boards) keeping domestic agricultural prices below world price levels. Both types of intervention may encourage producers to ignore the productive capacity of the land, with adverse consequences for sustainable development.[18]

19. Governments also under-price certain resources which may thereafter constitute inputs in production processes, either by providing them below their marginal cost, or by subsidizing private producers. This is particularly the case for prices of water, energy, pesticides and fertilizers, which are frequently set at less than the marginal cost to society, and even, in certain cases, less than the marginal cost of production, as for certain "below-cost timber sales". Because of such under-pricing, the resource is demanded in larger quantities than would otherwise be the case if marginal cost pricing was adopted. As a result, environmental damage occurs, either directly or indirectly, when these under-priced resources are used as inputs of production processes. This has both static and dynamic effects: resources are misallocated in the present, and are prematurely depleted, affecting future generations.

20. This type of policy-induced distortion is common in developed and developing countries alike. In developed countries, both subsidies in natural-resource based sectors and publicly administered resource prices that do not embody the full social cost of resource use are particularly relevant. As an example, subsidies are pervasive in the agricultural sector, where policies designed to secure self-sufficiency, promote food exports and increase farm incomes, are common in most OECD countries.[19] Water resources are another case in point where excessively low government administered prices for water resources continue to be the rule in a large number of these countries.[20]

21. In developing countries, price controls over natural resources are widespread. Although society experiences an overall loss of efficiency because of such control, food and energy prices are frequently subsidized in order to keep the price of essential goods low to benefit the poorest members of society. As well, and in order to encourage industrial and agricultural activity, the prices of fertilizers, irrigation water and energy are generally kept low. Whatever the objectives may be in intervening to keep prices below social (or even marginal private) costs, the cost of achieving these objectives can be very high,[21] and constitute a serious drain on government revenues, while the

resources so wasted could have been used for other purposes that could benefit poor populations equally well or better.

Box 2.

Water pollution in El Salvador and Costa Rica

The coffee processing industry makes extensive use of water: for transportation, for the removal of the skin and pulp of the coffee berry, and for the washing process. Water pollution and contamination has in consequence become a serious concern in countries like El Salvador and Costa Rica. The response to this concern has differed sharply in the two countries, however.

In El Salvador, charges for water use have been raised, and charges have been instituted for dumping contaminated water into the rivers. These internalization actions have prompted a positive change in the way water is used: water used in coffee processing is recycled; labour is used instead of water for such tasks as coffee selection; water collected after use in coffee processing is stored in pools, the surface residue skimmed off for use as fertiliser and the water itself chemically treated before being discharged.

In Costa Rica, by contrast, no attempts have been made to internalize the environmental costs of water use in the coffee industry: no incentives have been set in place to change production or consumption behaviour. As a result, rivers and water sources are more contaminated than those in El Salvador. Although water is more abundant in Costa Rica than in El Salvador, most of the surface water has been rendered unfit for any sort of consumption, necessitating the use of groundwater and acquifers, which are themselves vulnerable to chemical contamination.

Source: Segura, O.B. with J. Reynolds, "Environmental impact of coffee production and processing in El Salvador and Costa Rica", UNCTAD/COM/20 (a case study prepared for UNCTAD) August 1993.

22. Another policy-induced distortion which affects resource pricing arises when the economic rent earned from natural resource extraction and harvesting by private concessionaires is not sufficiently captured by governments through taxation.[22] The main illustration, whether in developed or developing countries, is the case of low or reduced rental rates on timber and fisheries.[23] This internalization failure exacerbates environmental destruction by: (i) creating super-normal profits which increase the rate of entry to the industry, as in the tropical logging industry; (ii) keeping the prices lower than the true private costs of resource extraction, which has, for example, created a situation in which high quality tropical timber is used for normally low-quality planking for construction purposes;[24] (iii) reducing government revenue below what it could have been with higher rents per unit of resource extracted and thus reducing investment in more sustainable management, such as the monitoring of concessionaires.[25]

23. Further examples of distortions induced by deliberate policy choices include the use of economic incentives for land conversion and clearance which often lead to the loss of forests and wetlands. Subsidized credit and tax allowances for cattle ranching leading to deforestation, or acquaculture farm subsidization leading to the destruction of wetlands, are illustrative examples.[26] Also damaging to the environment, and ultimately compromising the pursuit of sustainable development, is the failure to intervene in situations

where external costs are generated by the existence of open access to important resources. It is also worth noting that the high cost and short-term nature of informal credit often biases rural investments against long-horizon natural resource activities such as tree planting or conservation, and thereby contributes negatively to sustainable development.

24. Distortions affecting sustainable development do not arise solely from policies directed to the natural resource sectors. Policies which promote industrialization at the expense of agriculture may also promote inequality, underemployment and scarcity of rural credit. This, in turn, may discourage investments in land conservation and encourage encroachment on marginal lands, which together with the consequent social tensions, weaken the basis for sustainable development. Certain trade policies can also create problems. In developed countries, agricultural protectionism leads to much more intensive farming than is environmentally or economically justified. In addition, protectionism impedes the access of low-cost producers, with comparative advantage in certain manufactures, to developed country markets, thus raising consumer prices in developed countries while lowering incomes in developing countries. This can exacerbate environmental pressures in developing countries if the result is to force them to intensify exports of environmentally costly products or to constrain their investment in more environmentally-sound methods of production.[27] Moreover, the distorting effects of macroeconomic mismanagement, through monetary, fiscal and foreign exchange policy interventions, can be as detrimental to natural resource management and the environment as to other sectors of the economy. Increasing foreign debt, growing budget and trade deficits, or hyperinflation, in a framework of poverty and economic stagnation, can encourage environmental degradation and unsustainable development.

Box 3.

Policy failures in the Canadian cod fisheries

For many years, a defining characteristic of the Canadian economy has been its cod fisheries. Decades of Canadian university students have learned Canadian economic history primarily through books on The Fur Trade and The Cod Fisheries. Yet on 2 July, 1992, the Canadian federal government announced that it had imposed a two-year moratorium on cod-fishing in the Atlantic. What had happened to bring a once-proud $700 million per year industry to its knees in this startling fashion? The case study below documents the story of an environmental collapse due entirely to a failure to internalize external costs.

In 1977, Canada gained control of the 320 km. (200 mi.) economic zone off Newfoundland following the United Nations Law of the Seas Conference (UNCLOS) which allowed nations to extend their control of resources beyond the then traditional three mile limit. The Canadian federal government then took a fateful policy decision to foster the introduction of modernized "dragger net" trawlers, using high-tech fish-finding electronics and ice-breaking capacity. The dragger nets were virtual vacuums scooping everything from the sea bottom; the electronic gear allowed the boats to pinpoint theretofore unknown fisheries; and the ice-breaking capacity allowed them to enter winter resting areas which the fish stocks used to replenish themselves. The government also invested hundreds of millions of dollars in the establishment of two giant trawler companies, gave them half of the total available quota of fish available on the Atlantic coast, and established an "Enterprise Allocation" system which inadvertently encouraged trawlers to cull ruthlessly their bountiful catches by dumping overboard dead and dying fish so as to remain within the set limit.

The dragger nets replaced much of the fixed gear long-line fishing, traps and anchored net fishing that had sustained the fishery for hundreds of years up to that time. In consequence, between 1978 and 1988 the reported commercial catch (not counting the nearly equal amount dumped overboard) climbed from 135,000 to 266,000 tons. Environmental groups and the inshore fishermen who had long

Box 3 (cont'd.)

been practising sustainable fishing warned of the damage that would result from abuse of the dragger nets and high technology, but the federal government continued to set high allowable catches; it set 1992's allowable catch at 185,000 tons, despite the fact that in 1991 the cod fishery was already so decimated that the actual catch was only 127,000 tons. In a bizarre response, the government initially blamed seals - which had lived for centuries in harmony with the fish - for the fisheries' devastation and called for controls on seal populations. It also noted, correctly, that the very large foreign factory fleets from France, Spain and Portugal, replete with sonar and refrigerator and canning ships, had virtually pitched a permanent "camp" above the rich Atlantic cod fisheries outside Canada's 320-km economic zone, joining Canada's large ship fleet in "vacuuming" the sea clean of all sizes and all kinds of fish, both the mature and immature. Finally, in July 1992, recognising the collapse in the catch of legal size cod and that what cod were left were the young needed to bear the next generation of cod, the government imposed the moratorium cited at the outset.

In addition to the damage already caused to the ocean ecosystem, the economic impact of the policy failures cited here could be quite substantial: over 19,000 fishermen, plant workers and trawlermen in some 300 communities along Canada's east coast could become jobless during the two year moratorium. And instead of a well-managed sustainable fisheries supporting stable incomes and tax revenues to the federal, provincial and local governments, those governments face the prospect of spending over $1 billion to support the lives of the out-of-work fishermen and their families. Nor is cod the only fishery that has been decimated by failure to internalize environmental costs adequately: Atlantic salmon catches have been steadily declining for years. In 1967, commercial landings of salmon were more than four times higher than 1991's catch. Over-fishing, combined with industrial pollution and destruction of habitat have led to the demise of this economic base. Again, the federal government, unable to introduce an environmentally-sound policy soon enough, closed the commercial fishery altogether in all of Newfoundland, except Labrador, for five years in March 1992. Compensation of $40 million is to be paid out to the fishermen made unemployed by this decision.

Source: Drawn from Gallon, G.T., "Reconceptualising Economic Development: Brown Economics vs. Green Economics", The Human Economy Newsletter, Vol 14, No. 3 (Sept. 1993), pp. 1-12 with the kind permission of the author.

25. Policy failures are not the exclusive domain of governments. Although international development agencies, such as the World Bank or the International Monetary Fund (IMF) have made significant strides recently in taking environmental issues into account in the formulation of structural adjustment programmes (SAPs), there remains much to be done if these programmes are adequately to promote sustainable development. Questions regarding the social policy aspects of these programmes are not treated in the present paper; the focus here is rather on resource pricing issues. SAPs have made some progress in moving the prices of certain resources (particularly energy and food) towards levels which internalize full social costs; but complete internalization for all products, whether via regulation or economic instruments, is not yet a feature

of SAPs. Since these programmes are likely to define macroeconomic and sectoral policies for the remainder of the decade (and perhaps beyond) in a large number of developing countries, this failure to push strongly for sustainable development-enhancing internalization must be considered a serious defect.

26. Resources will not be priced adequately if property rights to the resources in question are absent, ill-defined, or insecure,[28] with the result that environmental losses and unsustainable development paths may ensue. In the particular case of open access or public goods, a failure by governments to establish property rights adequately prevents the capturing of the value of the environmental services of natural resources, thus providing little incentive for individuals to use sustainably or to preserve these services.[29] Equally, distortion will arise if in the case of a global open access externality such as biodiversity and species information, governments, particularly in biodiversity-rich developing countries, neglect to intervene when, for example, pharmaceutical companies receive monopoly profits from materials originating in these countries without being subject to control regarding the sustainable use of biological diversity, or without engaging in any internalization exercise.[30]

B. Instruments for internalization

27. As noted in the Introduction, the regulatory approach to improving environmental quality has gained widespread use, particularly in developed countries. It must be noted, however, that in some cases, regulations have proved to be legally or practically unenforceable, technically difficult to monitor and of insufficient economic weight (in terms of penalties for non-compliance) to constitute a deterrent adequate to effect fundamental changes in behaviour.[31] Recent evidence indicates that the costs of obtaining additional improvements through regulations can be significant in terms of failure to allocate pollution abatement efficiently across individual polluters, failure to provide sufficient incentives to reduce environmental costs, and failure to refrain from excessive intervention in the functioning of markets.[32]

28. Beyond the regulatory approach lies an entire array of policy approaches which take advantage of market principles in achieving objectives. The cost effectiveness of such "economic" instruments as well as the attractiveness, for governments with large public deficits, of savings or even the generation of funds through such instruments, combined with their dynamic efficiency, flexibility and relatively easy enforceability has led to increasing interest in the adoption of such instruments.[33] It must be said, however, that the widespread use of economic incentives as instruments for internalization is still infrequent in most countries.

29. For an economic instrument to function effectively as a stimulus to sustainable development, it must affect behavior, by creating an incentive sufficiently powerful as to make polluters and consumers change their decisions about which processes to use and which products to buy.[34] The particular methods by which this may be accomplished are discussed in the following paragraphs, together with brief references to the recent experience in the use of these instruments in both developed and developing countries.

1. Charges

30. Governments in some countries have already achieved some success in using charges which can be imposed either on the emission of pollutants degrading the environment (on air, water, soil, etc.), in which case they are called *emission charges* (fees); or on products that are harmful to the environment when used in production, consumed or when they become waste matter, known as *product charges* (fees or taxes). Other charges also used include user fees for the cost of collective or public treatment of effluents, and administrative charges including control and authorization fees to pay for the services of the regulatory

authority.

31. Emission charges create powerful incentives to reduce natural resource and environmental degradation as quickly as possible, since reductions of pollution bring with them the reduction of the tax or charge that the polluter must pay. They also create continuing incentives for the development and adoption of newer and better approaches to pollution control, and thus are likely to impact very positively on sustainable development programmes, particularly since the revenues collected can be used for poverty alleviation, equity enhancing, or other distortion-reducing purposes. Emission charges are fairly widely used in developed countries;[35] experience with emission charges in developing countries is limited.[36]

32. Product charges are levied on inputs to production processes and on the outputs of these processes. In practice, such charges have more frequently been applied to intermediate or final products than to inputs or wastes. Examples of product charges which are effective in altering the behaviour of consumers and producers include carbon taxes, energy pollution taxes, agricultural input taxes, as well as product charges (on pesticides, fertilizers, plastic bags or batteries, among others).[37] Gasoline taxes to control pollution may be applicable in cities of both developed and developing countries in order to internalize pollution-induced health costs, as well as reduce traffic congestion.[38]

33. Emission and product charges go some way towards "full cost" pricing, with the cost of a good being adjusted so that it reflects, to some degree, the reduction in social welfare caused by any environmental externality associated with it.[39] Such charges are thus internalization instruments designed to move an economy towards the production of less of the environmental externality in question.[40] For developing countries' governments, in particular, the fact that environmental taxes are, to a certain extent, self-policing and can constitute a source of government revenue, are advantages to be taken into account in deciding whether to use them.

2. Subsidies

34. Subsidies in natural resource based sectors, publicly administered resource prices and interventions that cause domestic agricultural prices to differ from world price levels are illustrations of subsidies generating environmental external environmental costs in both developed and developing countries.[41] Input subsidies such as pesticide or fertilizer subsidies as well as low water charges, subsidies in coal, oil, gas and electricity, and deliberate policies that may encourage the rapid depletion of natural resources and the environment (deforestation, biodiversity degradation, etc.) are commonplace. Governments have a crucial role to play in addressing resource and input under-pricing policies through appropriately correcting policy failures at the source of the externality, in particular in the areas of water, energy, pesticides and fertilizers.

35. Reducing or eliminating such subsidies yields both economic benefits and environmental gains in the form of health and ecological improvements (e.g., by correcting the misuse or excessive use of pesticides), increasing the rate of return to conservation measures (e.g., by negating policies which depress the price of land), or reducing air, water and solid waste pollution associated with the provision and consumption of energy (e.g., through the elimination of subsidies to energy).[42] In addition, as noted above, such subsidies constitute a serious drain on government revenues, while the resources so wasted could have been used for other purposes that could benefit poor populations equally well or better.

3. Marketable permits

36. A particularly interesting method of internalization is the creation of

markets where none exist. Marketable permits create markets to allow polluters to trade in a limited supply of pollution rights. Such internalization through emission trading has the following characteristics:[43]

Box 4.

Internalisation of external costs in Polish industry

Poland's environmental problems have received extensive attention in the international media since the early 1980s. Recent studies have estimated that environmental externalities amount to as much as 9% of GDP, to which must be added the transboundary effects of "imported" pollution deposited on Polish territory by polluters in other countries, which are estimated to increase the total damage by a further third. What is less well-known is the extent to which the Polish authorities have attempted to internalise the external costs of polluting activities by means of economic instruments.

A substantial part of the pollution problem in Poland is the historical legacy of the inefficient allocation of resources typical of non-market centrally-planned economies, which were characterised by excessive use of virtually all resources, including environmental resources. As a result of political and economic reforms initiated in 1989, this source of inefficiency is gradually being eliminated, by removing price distortions and perverse incentives which acted as subsidies for environmentally-unsound activities.The other source of Poland's environmental problems, the externalities observed in most economies with an extensive industrial sector, is being tackled by enforcing emission standards, by issuing permits to pollute, and by establishing emission charges; subsidies are also offered for environmental investment activities, financed by environmental funds.

The most distinctive feature of environmental management in Poland is its extensive system of pollution and resource fees collected by government and (partially) redistributed to firms and municipalities for abatement and conservation purposes.Environmental fees have existed in Poland since the 1970s, but in an economy where all essential inputs were allocated administratively, such instruments were doomed to failure because plant managers had little incentive to respond to price stimuli. Since the 1989 reforms, the incentive effect of the fees has been able to function, and has been sharpened by fee levels which rank among the highest in the world: in 1992, they accounted for 0.5% of GDP and provided as much as 58% of environmental investment financing.

There is still, however, a gap between the environmental damages attributable to polluting enterprises and what they spend on environment. In a sample of 112 major industrial polluters (accounting for 20-25% of Polish air and water pollution in 1992) it was found that the sum of expenditures for pollution fees, abatement activities and non-subsidised environmentally-linked investment was only 73% of the value of damages.This suggests that the most compelling internalisation strategy would be to raise such charges still further. On the other hand, the weight of the pollution fees in production costs in the sample enterprises was relatively high at 5% on average, 12% for some chemical plants and fully 67% in one coal mine. Since substantially higher charges would affect the short-term

Box 4 (cont'd).

competitiveness of the firms in question, there is reluctance to pursue such further internalisation on account of the potential employment effects. Indeed, by mid-1993, of the 112 enterprises surveyed, 5 had gone bankrupt, 27 were partially shut-down and 12 were still functioning despite severe non-compliance with environmental standards because of local unemployment problems.

Source: Broniewicz, E., B. Poskrobko and T. Zylicz, "Internalising environmental impacts of industry in Poland: A case study", Bialystok Technical University and Warsaw Ecological Economics Centre, January, 1994.

(a) Specification of a predetermined level of emissions or emission concentration within a specified area;

(b) Permits equal to the permissible total level of emissions, distributed among polluting firms and plants in the area;

(c) Permits tradeable among plants of a single firm, as well as among firms.

(d) Permission for firms that maintain their emission levels below their allotted level to sell or lease their surplus allotments to other firms or use them to offset emissions in other parts of their own facilities.

37. Tradeable instruments for internalization are easier to monitor and bear lower transaction costs and greater dynamic incentives than emission charges. Like charges, they give clear incentives for firms to seek less environmentally damaging techniques of production, particularly if the permits are steadily reduced in number (they can be given a finite life, or they may be purchased on the market by government agencies). Initial allocation of the pollution permits can be done on the basis of current pollution emission or of other considerations related to sustainable development including, for example, population as a way of vesting property rights with particular groups. Alternatively, firms could be invited to bid for the permits, and the permits sold at the market clearing price.

38. There is some experience to date in the operation of pollution permit markets. In the United States, a system of marketable pollution permits used for ambient air quality control has been in use for nearly a decade now, as part of an effort to implement the US Clean Air Act.[44] Other more recent cases have been reported,[45] including Singapore's system of auctionable permits for the consumption of ozone depleting subtances. Such permits would seem to be a very attractive way to internalize external costs without compromising sustainable development.[46]

4. Deposit refunds

39. When the externality consists of goods which may have negative environmental effects if abused in their use or disposal, deposit-refund systems - which work through a surcharge, placed on the sale of potentially polluting products, which is refunded when certain conditions are satisfied - provide one

instrument of internalization.[47] Particularly because of their low administrative costs, deposit-refund systems for beverage containers are widespread in both developed and developing countries. The implementation of such schemes for other articles such as batteries or car hulks has started to take place or is in the process of being very seriously considered.[48]

5. Property rights

40. As noted above, where property rights do not exist or are ill defined, no incentives are provided to individuals to use open access goods sustainably or to preserve the environmental services they provide. The allocation and enforcement of property rights as an instrument for internalization can be accomplished through the use of land titles, water rights, user rights (licensing fees, concession bidding), development rights or reassignment rights. In addition, some customary regimes for the management of common property resources may have an equivalent effect. It should be noted that property rights can be assigned for resources only if the condition of "excludability" can be met, i.e., the resource must be such that it is possible to prevent its being used. This in turn is largely a matter of institutional arrangements. Air is often cited as the archetypal "non-excludable" good, but measures like the Vienna Convention and Montreal Protocol concerning the protection of the ozone layer show that exclusions can be arranged; it is even possible to collect rent on the air, for example by the use of tradeable carbon emission entitlements.[49] It must also be possible to enforce property rights, once assigned; this depends on both administrative capacity and the cost of enforcement. Other conditions which need to be met if property rights are to become a valid instrument of internalization include the requirements that they be exclusive, transferable, secure[50] and conferred for a sufficiently long time period.[51] It should also be borne in mind that even if transferable property rights can be assigned, the question remains whether it is desirable to do so if sustainable development is to be served: to formalize property rights can make them an easier target for more powerful interests. How important an issue this is will depend on the particular social and institutional context.

41. If property rights and responsibilities are to be used as a way of internalizing external costs in the interests of sustainable development, it is evident that those to whom the rights are assigned should be able both to take decisions concerning the use of the resource in question and to implement those decisions.[52] Moreover, they will need to understand how the resource relates to its environment,[53] so that decisions are likely to be followed by the appropriate effect; for this reason, attention needs to be paid to the ownership rights of women. Similarly, as regards the ownership of royalty rights with respect to genetic resources, administrative practicality argues in favour of assigning the rights to national governments, but the understanding essential to effective management of the resources is likely to be situated at a more local level.[54]

6. Bonding systems

42. The "performance bond" is a quantity of money paid to the government, or its agent, prior to undertaking an action which may be environmentally damaging. If no more than a pre-specified level of damage depletion occurs, the bond is repaid; if the limit is exceeded, the bond is forfeit. Performance bonds are usually applied when the potential environmental damage is clear and its source readily identifiable, as in the case of surface mining.[55] However, they can be applied to the internalization of a great variety of external environmental costs, including the use of open access forests, or the depletion of privately owned resources (an intertemporal issue).

7. Information systems

43. Information is a major input to sustainable development.[56] The first step to the internalization or avoidance of an externality is to be aware of the existence and nature, and better still of the magnitude of the externality. This

requirement underlies Principle 10 of the Rio Declaration: ignorance serves the externaliser.[57] The generation and skilful dissemination of information on the environmental costs of certain activities, and on the interaction between economic and environmental choices, can alter the public perception of environmental risks and problems, thus leading to more sustainable approaches.[58] In many developing countries, the very limited availability and poor quality of information, very often due to the limited reliability of natural resource endowments data or to communication difficulties and weak institutional structures, accentuate the difficulties: education, information and awareness provide the essential incentive to make the other types of measure discussed in this section effective. Conversely, the application of other measures educates and increases awareness. This is the ultimate internalization: environmental consciousness fully internalized into the kind of normal behaviour which is not questioned. Moreover, a requirement that information be made public can be viewed as a market instrument because it enables consumers to choose, and it can be effective in altering corporate behaviour.[59] Another informational device, "Prior Informed Consent", which appears in a number of international instruments, can raise awareness of hazards in countries when their consent is sought.[60]

44. Finally, it is an important aspect of information to establish that the environment impacts on economic welfare. Adequate consideration of integrated environmental economic accounting and natural resource accounts can serve this last purpose by illustrating the strong link prevailing between the environment and national economies, and be an effective incentive for internalization and sustainable development. Efforts towards environmental-economic accounting have been the subject of many studies and research in these recent years. Although most of the economic litterature with respect to environmental economic accounting relates to developed countries' experience, recent studies are looking more specifically at developing countries.[61]

8. Liability and litigation

45. The Rio Declaration, in Principle 13, includes liability and compensation among the instruments for internalizing external costs.[62] Liability and compensation are economic instruments: if the entity causing specified external costs is apprehended, it is required to make a payment. The external cost is a contingent liability and in appropriate circumstances can be converted into a known cost by means of insurance. If external costs are to be internalized through insurance, those who cause the risk must be able to insure, which requires being sufficiently liquid to afford the premiums; also, the administrative costs facing the insurance companies must not be so high as to discourage them from undertaking the business. It is consequently rare, especially in developing countries, for artisanal enterprises using hazardous products to insure against the liability which could be attached to them.

46. It should be noted, however, that insurance functions when a large number of events of moderate cost are possible with low probability each: beyond a certain magnitude of risk, the insurance industry is unwilling to provide cover (e.g., for major nuclear accidents). In many countries, normal practice in this latter case is for government to accept ultimate liability. Since governments do not insure for such eventualities, the end result is that the contingent liability is carried by the public, including in particular the eventual victims. As a result, large risks are externalized, and activities which give rise to them are subsidized to that extent. Internalization in such cases would seem to be best handled through the precautionary approach, as set out in Rio Principle 15.[63] Apart from the precautionary approach and insurance, another way of dealing with external costs which may be open to those who might be held liable is dissimulation. The method is widely used because it is particularly (but not exclusively) suited to small polluters. In the absence of enforcement, it is often the method with the lowest private costs.

47. Enforcement of liability often involves litigation, which is economic in

nature if the sanction imposed on the party at fault takes the form of a compensation payment or a fine. Litigation involves apportioning blame and thus requires the establishment of the causes of the external costs at issue; this contributes to prevention in the future and enhancing public awareness and information. On the other hand, litigation tends to be costly and is therefore better suited to high-income societies. It is also unlikely to internalize external costs if the victims are individually poor relative to the polluters, if they are poorly organized or if they lack the education required to exploit the court system effectively. Furthermore, recourse to litigation seems to be culture-specific.

9. Voluntary schemes

48. There is a growing number of voluntary schemes for internalization adopted by enterprises individually, nationally or internationally. Among the international ones can be mentioned the Responsible Care programme of the chemical industry through the International Council of Chemical Associations[64] or the World Federation of Engineering Organizations' Code of Environmental Ethics.[65] At UNEP's instigation, 38 banks[66] have signed a Statement by Banks on the Environment and Sustainable Development. The International Chamber of Commerce's Business Charter for Sustainable Development was adopted in 1990; by October 1993, 1159 companies and business organizations had adhered to it, about one third of them in developing countries.

49. Voluntary codes are particularly effective when they stimulate the search for ways of reducing internal costs without increasing external ones. This may involve improved technologies or changes in taste, i.e. a shift in the demand curve for intermediate goods, as for example in the shift to the use of recycled paper for corporate communications. Where they entail an increase in corporate costs, they are more effective when competing firms are subject to the same constraints, as, for example, in an industry which is dominated by a few large firms. Whatever the structure, however, free riders can threaten a voluntary agreement; it is important therefore that measures affect all firms in the industry.

10. Other policy instruments

50. Increasing attention is being given to other instruments for the internalization of environmental costs, such as environmental funds and environmental management control agreements. Environmental funds are constituted from fines or charges levied on polluters; loans are then made (or grants given) to firms investing in pollution control technology. This instrument has been in use in Japan, as well as in certain developing countries (Republic of Korea and Thailand).[67] Pollution control agreements take place between industry and government or local communities and rely on moral suasion and self-policing to effect behavioural changes vis-a-vis the environment. They are widely employed in Japan and Indonesia, and although not legally binding, their strength is based on the demonstration effect achieved when publicity is given to the names of firms not honouring their agreements.

C. The choice of the right policy mix

51. The selection of the correct mix of policy instruments for internalization implies a careful balancing in the choice of the instruments. As an illustration of how complex this can be, a brief comparison of alternative market-based internalization techniques is in order. A large number of possible criteria could be used for these purposes; here, the following will be used:[68]

Environmental effectiveness: The environmental effectiveness of economic instruments is determined largely by how polluters react to the continuing incentives such instruments provide for pollution abatement, technical innovation, and product substitution.

Economic efficiency: This requires that the economic cost of complying with environmental requirements is minimised.

Equity: Distributive consequences vary according to the types of policy instruments applied.

Flexibility: The ease and speed of adjustment of the instrument to changing conditions can be an important factor when administrative or parliamentary procedures are required to effect alterations to the basic parameters of internalization instruments.

Acceptability: For an instrument of internalization to be acceptable, those affected must be informed and consulted. In addition, certainty and stability over time as regards their basic elements are important conditions for acceptance of such measures.

52. Thus, on the criterion of environmental effectiveness, emission charges may be preferred to marketable permits based on a fixed amount of permissible pollution which thus allow firms to pollute as much as before as long as they remain within the allowable limits. On the other hand, these limits can always be adjusted downwards to meet revised objectives; also, marketable permits would be preferred on grounds of flexibility because of their easier and more automatic adjustment to changes in markets than in the case of charge systems. Moreover, whilst in general marketable permits seem to be superior instruments to emission charges in terms of economic efficiency, price-based systems (emission charges) may be preferred in the case of developing countries, because of their potentially lower costs of implementation and monitoring.

53. However, it must be borne in mind that the marginal utility of money is not the same for everyone: the poorer one is, the higher its marginal utility. If costs are minimized by shifting them to the poor, lower costs may correspond to an even greater loss of welfare, to a heavier burden of external environmental costs; sustainable development could hardly be served in such conditions. Those who have more means at their disposal have more choice in the activities they undertake: the poor have less choice. In so far as the aim is to change behaviour, it is likely to be sensible to choose measures which impinge more on those with more resources; indeed this can be related to Rio Principle 7, which refers to common but differentiated responsibilities[69] and Principle 8, which refers to reducing and eliminating unsustainable patterns of production and consumption[70].

54. Finally, as regards the criterion of equity, it may be noted that the distributive impact of emission or product charges or taxes would depend upon how the revenue is used. Similarly, with marketable permits, the distributional effects will differ according to their initial allocation. Priority to the poor - the basis of equity considerations - also has implications for the allocation of property rights. If different allocations can be imagined which have the same implications for the other criteria discussed in this section, the one which best reduces poverty or decreases disparities in standards of living would seem to be preferable. An environmental value-added tax (E-VAT) to internalize resource value at the points at which the resources are introduced into the economic process might in a similar way distribute the revenue thus raised in a manner more favourable to the poor.

55. In the light of these observations, a broad agenda for feasible internalization leading to sustainable development, which would be equally valid in both developed and developing countries, could look as follows:[71]

(a) Attenuation or elimination of policies that distort resource allocation, in particular, environmentally-unsound subsidies;

(b) Correction of fundamental incentive failures, such as insecure or absent property rights, or unpriced resources;

(c) Gradual introduction of other internalization instruments of a regulatory or economic nature in a sequential form:
  - (i) internalization through revenue generating instruments such as charges (product charges may be easier to implement);
  - (ii) use of the revenues to increase knowledge and information availability, and to reinforce institutional capacity in the environmental area;
  - (iii) introduction of economic instruments for internalization (marketable permits, emission charges, etc.);

(d) Internalization of external environmental costs induced by the effects of public projects, sectoral and macroeconomic policies.

Such a programme would also need to be complemented, at the international level, with measures to ensure that intragenerational equity considerations are also respected between nations when local, transboundary and global external environmental costs are confronted. It is to these aspects to which this report now turns in chapter IV below.

IV. THE INTERNATIONAL DIMENSION : COOPERATIVE INSTRUMENTS FOR INTERNALIZATION

56. The discussion to this point has focussed on measures which can be taken by nation-states individually to internalize external costs which have an impact on sustainable development. A question which may be posed in the intergovernmental forum provided by UNCTAD is to what extent international cooperation can help to speed up the process of such internalization, or may even be required for the internalization to occur at all, and what basic forms such cooperation could take. The Board may wish to consider this question in its debate on internalization.

57. For its part, the secretariat is of the view that global optimality demands global cooperation. Developing countries face, however, a policy conundrum: throughout the developing world, there is a strongly-perceived need for the modernization of commodity production and for industrialization, whether in the form of strengthening an incipient process (as in much of Africa and parts of Asia); of reviving a process which has been interrupted (as in parts of Latin America); or of continuing an ongoing, even rapid, process (as in parts of South-East Asia). But without major changes in the technology of industrial and commodity production, such a development strategy is likely to imply further environmental degradation. Thus, the imperatives of environmental protection and of development may well pull in opposite directions. Resolution of this conundrum would seem to require of policies that they meet three main criteria:

(a) that they be capable of bringing about the internalization of external environmental costs;

(b) that they allow continued economic development in all countries, and enable the process of industrialization and modernization of commodity production to proceed unimpeded in those countries in which this process is incomplete; and

(c) that they provide appropriate incentives to ensure that the development process in developing countries, and the replacement, renewal and expansion of industrial facilities in both developed and developing countries, embody technology and practices which are environmentally sound.

Unfortunately, the incentives facing individual countries frequently work in the opposite direction because, even though it is in the interest of all nations to cooperate and reduce their rate of use of environmental resources, every nation can minimise economic costs by "free-riding" on the virtuous behaviour of those which cooperate.[72] Therefore, an efficient system of incentives at the international level (as part or not of environmental agreements) is needed to induce cooperative environmental protection. Moreover, in line with Principle 7 of the Rio Declaration, special attention needs to be paid to the search for, and adoption of, positive incentives directed towards the developing countries.

A. Financial transfers

58. One type of such incentive is financial in nature. It may take the form of the debt-for-nature swap, a debt conversion in which instead of acquiring the equity, the holder of discounted debt agrees to help the indebted country conserve a natural resource.[73] There is already considerable experience with this incentive, as such swaps have occurred in many developing countries. Another form of such transfers, with which there is less experience, is the "side payment" or lump sum payment transferred directly to compensate a country for certain actions, such as not developing a resource in an international environmental agreement.[74]

59. A further form of financial transfer in this context is the provision both of assistance or loans for environmentally beneficial (or at least benign) projects and of bridging finance for the changing of production methods. Such transfers are being made increasingly through bilateral aid programmes and multilateral financial institutions. The most recent institutional example is provided by the Global Environment Facility (GEF), whose establishment also reflects global agreement that the actions that a single country can take to improve the environment also benefit other nations.[75] Other international cooperative instruments linked to project finance include "external offsets" or "joint implementation", under which countries with agreed national emission targets are credited with meeting these targets either by curtailing their own emissions or by investing elsewhere to reduce emissions so that the total of national emissions minus the amount saved by those external investments would meet the target.[76] This approach is included in the Framework Convention on Climate Change and has been introduced on an experimental basis by Norway.[77]

60. Other mechanisms at the international level might be considered by governments as an alternative or a complement to an agreement on domestic emissions. One such could be the use of internationally tradeable emissions permits allocated according to internationally agreed criteria. (It is on these grounds that UNCTAD has recommended allocating tradeable carbon emission entitlements in proportion to adult population.[78] International emission taxes could also be a very effective means of raising prices to reflect external costs. In this case, raising the revenue and deciding how it is to be spent are two distinct questions. The conventional view[79] of public economics is that "earmarking" is a potential source of inefficiency in fiscal decision-making. On the other hand, earmarking of environmental taxes to a particular type of expenditure may encourage greater popular support for the measure than if the revenues were simply to be allowed to augment the general resources of government.[80] This suggests that such taxes could be paid in proportion to emissions, and redistributed to ensure a net transfer from richer to poorer countries. Revenues could flow through a central international clearing fund, an environmental equivalent to the Bank for International Settlements in the financial domain.[81]

61. An additional instrument which would appear to hold considerable promise is a broadly-based tax on added-value, to offset via the market the underpricing of resources which both causes environmental degradation and comes at the expense of the developing countries, where the underpriced resources are located or where a disproportionate share of the external environmental costs fall. Such a tax, which might be called an "environmental value-added tax (E-VAT)", could be designed in such a way as to take distributional implications directly into consideration. Less broadly based, but perhaps easier to implement would be a

small international levy on air travel, to be earmarked for sustainable development purposes. As with the emission tax, such a tax could be channeled through a central international clearing fund.

B. International commodity-related environmental agreements

62. Production of primary export commodities is an important source of environmental damage in developing countries.[82] Because of the potential effects of unilateral internalization by commodity producers upon their competitiveness, and because many countries which export commodities are poor, the need for international cooperation is particularly great in this area. As a response to this, it has recently been proposed to set up international commodity-related environmental agreements (ICREAs). An ICREA would be an intergovernmental agreement to establish, for a specific primary commodity, an international framework to allow commodity-exporting developing countries to recoup the costs of producing the commodity in a (more) sustainable way.[83] This form of internalization would implement a de facto correction of the under-pricing (in terms of the environmental and natural resources costs involved)[84] of internationally traded commodities, together with a compensation to developing country exporters for the costs of transition to environmentally preferable production technologies and for diversification costs.

63. The ICREA proposal has among its main advantages that:

(a) it would induce minimal retail price changes because the cost of producing a commodity is only a small fraction of that retail price;

(b) compensation would be a contractual obligation;[85]

(c) the revenue raising device would establish a link between the volume of commodity imports and the amount which the importing country should transfer to the international fund from which the ICREA would pay compensation to exporting countries. This could be realised via import levies, but if the price elasticity of import demand were high, other financing devices could be used as well.

It has been argued against this proposal that the external environmental costs arise from the techniques used to produce the commodity, not from the commodity itself.[86] A counter-argument could be, however, that compensation can be used to deal directly with the correction of these production techniques.

C. International trade instruments

64. Certain trade policies can conflict with the objectives of sustainable development. In developed countries, agricultural protectionism leads to much more intensive farming than is environmentally or economically justified. In addition, protectionism impedes the access of low-cost producers, with comparative advantage in certain manufactures, to developed country markets, thus raising consumer prices in developed countries while lowering incomes in developing countries. This can exacerbate environmental pressures in developing countries if the result is to force them to intensify exports of environmentally costly products or to constrain their investment in more environmentally sound methods of production.[87] Where they thus stimulate a natural resource-based export specialization of many developing countries in the presence of poverty and poverty-related environmental problems, such policy-induced distortions exacerbate the problem of intra-generational inequity between countries.

65. Trade liberalization and environmental protection are however in general fully consistent with each other. Nevertheless, if the internalization is not implemented in pace with trade liberalization, such liberalization may merely

transmit external environmental costs to other economic agents. Although this is not an argument against trade liberalization, it nonetheless implies that the contribution of trade liberalization to sustainable development will be achieved only when the liberalization is accompanied by government policies to ensure the adjustment of economic incentives to environmental objectives.

66. Policies to internalize external environmental costs may affect market access and international competitiveness; this subject will be treated in depth at the first part of the forty-first session of the Board. Since the internalization of environmental costs may increase the private costs of production,[88] it has been argued by some observers that concern about potential competitive disadvantage and ensuing trade losses may inhibit countries from moving towards fuller internalization.[89] This has resulted in calls for the harmonization of production standards and the application of countervailing duties or other measures to "level the competitive playing field" or to offset hidden subsidies and "ecodumping".[90] It may be noted, however, that empirical and analytical work indicate that environmental countervailing duties are very difficult to justify from either a trade or an environmental point of view.[91] Whatever the merits of these differing views, however, it is clear that a cooperative international approach will be required to resolve potential problems.

D. International institutional incentives for environmentally sound technologies

67. Technologies already available can provide solutions to a wide range of the recognized problems of the environment and potential future technologies hold out the prospect of even more substantial improvements in production techniques, geared towards the practical implementation of environmentally sound, sustainable development in those sectors and countries which apply these techniques.[92] These innovations will, however, promote sustainable development on a global level only if the international community works out new cooperative arrangements to create incentives in all countries for changing techniques. Agreements reached at Rio reflect international recognition of the need to facilitate and finance the transfer of environmentally sound technologies "on favourable terms", as manifested in both the Framework Convention on Climate Change and the Convention on Biological Diversity.[93] These represent early steps towards the arrangements suggested above; much more will need to be done if environmentally-sound technologies are to be sufficiently widely diffused as to ensure that production techniques everywhere on the globe are coherent with the precepts of sustainable development.

68. In the context of UNCTAD, the Ad Hoc Working Group on the Interrelationship between Investment and Technology has highlighted in its work programme the need to consider policies and measures for the promotion, development, dissemination and financing of environmentally sound technologies (ESTs), particularly in developing countries. At its second session the Working Group noted with satisfaction the report of the Workshop on the Transfer and Development of ESTs (Oslo, 13-15 October, 1993) organized by the UNCTAD secretariat and the Government of Norway. The Workshop considered a diverse array of mechanisms, some already established and in need of improvement, others of a more innovative nature. It also identified a number of priority elements for an action programme in this field, including among others, the lack of information, awareness and training; benchmarking as an effective instrument by which to assess, monitor and encourage best practice standards at the firm level; development of effective regulatory structures and enforcement mechanisms; and a need to provide for a financial instrument, comparable to the global conventions, for addressing local problems with environmental, technological and developmental dimensions. In all the above fields, the Workshop further identified areas for additional study and research.

69. Further discussion of this issue will have taken place at the third session

of the Ad Hoc Working Group on Investment and the Transfer of Technology, which will meet just prior to the current session of the Board. At the time of writing (late 1993), however, it seems relevant to note a few points. Thus, to internalize the fixed costs of changing to cleaner technologies, "environmental benefit fees" (EBFs) could be levied to fund the so-called "incremental cost of technology switching", as has been recognized both by the Montreal Protocol (on CFCs) and by the Global Enviroment Facility (GEF), and as may be considered under the framework of the recently ratified Convention on Biological Diversity. In the case of the large-scale modern sector, the need will be for EBFs to provide finance in the form of low interest loans with most of the development and installation of new techniques being done in-house. By contrast, the small-scale artisanal sector of agricultural small holders, fishermen and miners tend to face severe credit constraints and hence require financial assistance and training.

70. As regards running costs, it is necessary to determine if the costs of operating the new technology are higher than under the old technology.[94] If indeed the new technology involves higher running costs, internalization can be accomplished through the use of an "environmental premium" charged to retailers who may or may not pass them on to consumers.[95] The operation of this instrument would require monitoring or certification (via "eco-labelling") to ensure that a particular commodity or product is produced with a clean technology. In this connection, it is worth noting that recent cases have been reported of commodity producers planning to shift or having already shifted to sustainable production without any increase in the retail price.[96] Thus, whether fixed or running costs are considered, in both cases there is clear scope for international cooperation in promoting sustainable development through the internalization of the external costs associated with the failure to use clean production technology.

V. CONCLUSIONS

71. The achievement of sustainable development requires policies to promote intra- and inter-generational equity and a much increased recognition of the value of the environment. Much of the mismanagement of the environment is due to distortions induced by governmental policies which entail intervention on existing markets with environmentally unsound consequences, or otherwise fail to set in place the conditions for producers and consumers to take proper account of the full costs of resource use in their decision-making processes. The internalization of external environmental costs is a valid policy choice for addressing these failures and thus creating the conditions for sustainable development.

72. In the choice of the right policy mix of internalization instruments, account should be taken of their: (i) environmental effectiveness; (ii) efficiency in achieving objectives; (iii) impact on equity; (iv) political acceptability; and (v) flexibility in adapting to changes. As regards their implementation, a pragmatic and flexible approach should be adopted, particularly to avoid drastic changes and political disruptions. Moreover, assistance needs to be given to developing countries in order to provide them with the necessary new capital equipment and skills needed for the adoption of less environmentally damaging techniques than those currently in use.

73. Although several factors favour the adoption of economic over regulatory instruments, especially because of their superiority in terms of cost-effectiveness, experience with their use is still limited, particularly in developing countries, and regulations are in many cases needed to complement economic instruments. Full private cost recovery, including the removal of distortive subsidies inducive of external environmental costs, appears in this context to be a promising approach to ensuring sustainable development.

74. The feasibility of the internalization approach remains very dependent on

the strategy selected for its implementation. One such strategy, which has been favoured in the present report, would have countries start by attenuating or eliminating policies distorting resource allocation; implementing revenue-generating internalization mechanisms (using revenues to increase knowledge and reinforce institutional capacity); and subsequently introducing other economic instruments. This approach also requires the careful use of sectoral and macroeconomic policies to ensure, in particular, that distorting subsidies be removed, especially from the agricultural sector.

75. At the international level, where there is less experience with internalization than domestically, there is a need for the international community to adopt creative approaches to spurring the implementation in all countries of measures which will reduce or avoid external costs which impinge on the environment and thus on sustainable development. Thus, international agreements on reducing emissions (tradeable carbon emission entitlements) and international commodity-related environmental agreements, or international commodity agreements with environmental provisions, can provide all participants with positive incentives for the internalization of environmental costs - and, properly designed, can dissuade countries from refusing to participate. In addition, and precisely because external environmental costs frequently arise from the techniques of production rather than from the product, cooperative approaches to providing incentives for switching to more environmentally sound technologies also deserve careful consideration. Eco-labelling and other kinds of certification of environmental sustainability or environmental premiums constitute valid internalization instruments encouraging the spread of sustainable production methods.

76. Finally, open markets remain a key to the international transmission of internalized environmental costs; this implies that the internalization should proceed apace with trade liberalization and that there be a greater integration of trade with environmental policies. In addition, international cooperation will be needed to minimize the negative effects of regulations or economic instruments on trading partners, and particularly the developing countries.

77. In the light of these conclusions, the Board might wish to request the Standing Committee on Commodities to examine in depth the imperfect internalization in commodity producing and consuming countries of external environmental costs. This could focus on the issue of resource pricing and its implementation, including ways of ensuring global cooperation on instruments for internalization supportive of sustainable development, for example through the ICREA or other proposals. The Board might also wish to consider in detail at the second part of its forty-first session the issue of environmental finance, including several ideas broached above, such as the E-VAT, the environmental clearing-house and tradeable emission permits.

NOTES

1. The Board had previously considered issues relating to sustainable development on several occasions, on the basis of documentation prepared by the UNCTAD secretariat. The decision to hold regular discussions is, however, a new feature.

2. It should also be mentioned that one of the elements of the work programme of theCommodities Division of UNCTAD is to consider the internalization of environmental costs and resource values, including biodiversity. This activity is being developed in order to respond to the request made in item 5 of paragraph E of the work programme of the Standing Committee on Commodities for the "Examination of the manner in which prices of natural commodities and their synthetic competitors could reflect environmental costs".

3. Rio Principle 16 reads as follows: "National authorities should endeavour to promote the internalization of environmental costs and the use of economic instruments, taking into account the approach that the polluter should, in principle, bear the cost of pollution, with due regard to the public interest and without distorting international trade and investment." The Rio Declaration on Environment and Development is given in A/CONF.151/26 (Vol. I), Chapter I, Annex I.

4. In summary, two conditions are essential for an external cost or benefit to exist: (a) the activity by one agent must cause a loss/gain of welfare; and (b) the loss/gain of welfare must be uncompensated. For more details see Meade. J.E. *The Theory of Economic External environmental costs*. Geneva: Institut universitaire de hautes etudes internationales and Leiden: A.W. Sijthoff, 1974 and Pearce, D.W. and R.K. Turner. *Economics of natural resources and the environment*. Baltimore, Maryland: John Hopkins University Press, 1991, chapter 4.

5. WCED. *Our Common Future*. Oxford: Oxford University Press, 1987, p. 43.

6. Rio Principle 3 reads as follows: "The right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations."

7. Rio Principle 5 reads as follows: "All States and all people shall cooperate in the essential task of eradicating poverty as an indispensable requirement for sustainable development, in order to decrease the disparities in standards of living and better meet the needs of the majority of the people of the world."

8. See Dommen, E. (ed.) Fair Principles for Sustainable Development. Aldershot: Edward Elgar for the United Nations, 1993.

9. See Goodland, R. and H. Daly, "Why Northern income growth is not the solution to Southern poverty", *Ecological Economics*, Vol. 8, No. 2 (Oct. 1993), pp. 85-101 for a rich discussion of these ideas.

10. This calculation is based on an assumed growth rate for the industrialized countries of 2 % p.a. and for the former socialist countries of Eastern Europe of 3 % p.a. over the 50 year period. The developing country share in world GDP is currently in the order of 30 %; it would rise to almost 70 % in this scenario.

11. Non-excludability occurs when no individuals can be excluded from the enjoyment of a good. The essence of a public or open access good is that the consumption of the resource by one individual does not prevent others also consuming it (''non-rivalry"). Air pollution is non-rival as its impact on any individual in a polluted area is not altered by the entry of another person into that area.

12. For example, in agriculture, environmental costs passed on might take the form of increased downstream flooding or sedimentation, or the damage that an upstream rice farmer's use of pesticides causes to a downstream fish farmer who uses the same water source. Globally, the emission of CFCs causing ozone depletion, or the use of fossil fuels threatening global climate change through the greenhouse effect, are additional illustrations of what can be called public open access "bads" whose internalization transforms them into "goods".

13. See Harvard Institute for International Development Research Review, Vol. VII, No. 1 (Fall, 1993), p. 1.

14. An example occurs in the choice between carbon taxes and energy taxes: a carbon tax may induce a reduction in carbon emissions, thus internalizing certain costs, but it may at the same time encourage recourse to nuclear or hydroelectric energy, thereby aggravating other external costs.

15. The "command" specifies that polluters must not exceed a predetermined level of environmental quality, while the "control" monitors and enforces the standard. The main characteristic is that the polluter has no choice but to conform to regulations or suffer the imposition of sanctions through judicial and administrative procedures. Such regulations are frequently enforced by threats or fines and other penalties, including in some cases imprisonment. See OECD *Economic instruments for the protection of the environment*. Paris, 1989. As an illustration, in 1957 the government of Costa Rica banned the import, sale or use of mercury-based fungicides for the control of coffee plant diseases. In 1975 further controls were introduced on the use of fungicides that contained arsenic or lead. In 1990 a complete ban on the use of arsenic pesticides was introduced. See Segura, O. "Environmental impact of coffee production and processing in El Salvador and Costa Rica", prepared for UNCTAD, (1993). Poore reports as well that Indonesia has implemented a policy of limiting the quantity of timber to be harvested per hectare, through a permits system. To prevent abuses of logging permits in Indonesia, in 1989, 48 concessions were revoked and 37 others suspended. Also, fines totalling US$ 4 million were issued, for cutting outside designated blocks, harvesting more than was allowable, or felling unapproved species. See Poore, D., "No timber without trees: sustainability in the tropical forest", Earthscan, London, 1989.

16. OECD. *Recommendation of the Council on guiding principles concerning international economic aspects of environmental policies, Annex 1: Note on the implementation of the polluter-pays principle*, Paris (1972), para 3. Reprinted in Dommen (op. cit.), Annex I.

17. Agricultural policies in developed countries, by inflating prices and per acre revenue, induce farmers to use more inputs and adopt chemical-intensive monocultures that lead to soil erosion, chemical run-off, loss of biological diversity, and conversion of once-natural ecosystems to cropland than would otherwise take place. See Repetto, R., "Trade and environment policies: Achieving complementarities and avoiding conflicts", World Resources Institute, Washington, July 1993.

18. It should be noted that the power of marketing boards has now decreased worldwide.

19. These support programmes encourage over-production of crops that are highly erosive, the cultivation of lands that tend to be more subject to soil erosion and moisture deficiencies, or the conversion of wetlands and forestland to agricultural production. High and stable prices for agricultural commodities also influence tillage, practices, the use of fertilizers and pesticides, the amount of excess manure, and the intensity and use of soil resources. See OECD, *Agricultural and environmental policy integration: Recent progress and new directions*. Paris, 1993.

20. See OECD, *Resource Pricing*. Environmental mimeograph, Paris, 1991.

21. Underpricing of water has encouraged excessive use of water by agricultural producers, by mining and by agro-processing plants. Under-pricing energy (including electricity) causes air pollution, excess and inefficient use, and depletes energy sources faster. Under-pricing pesticides and fertilizers encourages inappropriate and excessive use with important impacts on human health and the environment. In Mexico, farmers pay only 20% of the full production cost of irrigation water, while in Sri Lanka farmers pay only 60% of the full cost of nitrogen fertilizers. See Pearce, D.W., "The internalization of environmental costs and resource values: A conceptual study", A report to UNCTAD by CSERGE and EFTEC, 1993. A study of farmers working with pesticides in the Philippines found that 55% of them displayed abnormalities in the eyes, 41% abnormalities in the lung and 54% abnormalities in the cardiovascular system. See Coote, B., *The trade trap: Poverty and the global commodity markets*. London: Oxfam, 1992.

22. By taking too small a portion, the government allows others to capture rents. This is also applicable to the appropriation of the forest's value as reservoir of genetic information and biological diversity, a value which is largely ignored. It should be recalled that, in theory, rental rates can be set very high since, for example, forest concessionaires or pharmaceutical industries gain economic rents for practically nothing.

23. Experience with rents on minerals is most successful and shows rent captures often over 80%. However, rent capture in timber and fisheries is often much lower at less than 50% of the full user cost. While this may be due partly to technical reasons, and because of the local, transnational and global nature of this type of open access externality, it is also due to poor management and political factors.

24. The wood is mostly consumed by the construction industry in Japan, often for moulding concrete panels. Estimates suggest that over 25% of the tropical timber imported was used to make these concrete panels. See Pearce, D.W., (1993) op. cit.

25. It should be noted, however, that rental rates, although still low, are being increased for minerals timber and fisheries. For example, since 1987, the Philippines has raised forest rents whilst the island nations of South Pacific set up the Fisheries Forum Agency (FFA), in 1980, in order to increase their share of the rent from fisheries.

26. In Brazil, cattle ranching, which was encouraged by subsidized credit and tax allowances, accounted for 16% of deforestation in the State of Mato Grosso before 1970, and 20% in the State of Para. Subsidies for acquaculture farms lead to the destruction of wetlands, which act as breeding ground for capture fisheries. In Asia, where the problem is the greatest, it is estimated that, at least 1.2 million hectares of mangroves have been converted into acquaculture ponds. See Economic and Social Commission for Asia and the Pacific (ESCAP), "State of the environment in Asia and the Pacific 1990", United Nations, Bangkok, 1992.

27. In the late 1980s, about half of all developing countries' exports still comprised fuel, minerals and other primary commodities. Thus, trade distortions reduce developing countries' export revenue, and for this reason, the funds available to introduce environmentally improved methods of production. See Repetto, R., (1993), op. cit.

28. There is no reason for economizing on, paying for, investing in, or conserving a resource without an assurance of secure and exclusive rights over that resource, without having the possibility of recovering costs through use, lease, or sale, and without an assurance that such rights can and will be enforced. See Panayotou, T., "Economics of environmental degradation", in Markandya, A. and J. Richardson (eds.). *Environmental Economics: A Reader*. New York: St. Martins Press, 1992.

29. For example, it would have been a policy failure for the government of Thailand not to undertake to issue secure land titles to its farmers when it was established that the cost of titling was only a small percentage (10%) of the potential benefits. See Panayotou, T., (1992), ibid.

30. For a discussion on ways of appropriating the value of biodiversity information, see Aylward, B. A., and E. Barbier, "What is biodiversity worth to a developing country? Capturing the pharmaceutical value of species information", International Institute for Environment and Development, London Environmental Economics Centre, Discussion Paper 92-05, London, November 1992. For theoretical overviews of contracting and property rights issues, see Sadjo, R.A., "Property rights, genetic resources, and biotechnological change", *The Journal of Law and Economics* Vol. 35(1), 1992, pp. 199-213, as well as Simpson, R.D., "Transactional arrangements and the commercialization of biological diversity", ENR Discussion Paper 92-11, Resources for the Future, Washington, D.C. 1992.

31. High bureaucratic cost, large informational requirements and problems of sociocultural acceptance are generally advanced as factors impairing the functioning of a regulatory framework to protect the environment, especially in developing countries. See OECD, *Economic instruments for environmental management in developing countries*. Paris, 1993, as well as OECD, *Environmental management in developing countries*. Paris, 1991.

32. Other disadvantages of the regulatory approach to internalization are the need for administrative agencies to become experts in the pollution regulated; the need to collect and analyze considerable technical and economic information; and the fact that it constrains the choices open to polluters, or elicits only perfunctory compliance, rather than encouraging polluters to develop innovative or cost effective internalization procedures.

33. At the OECD Environment Committee meeting, in 1991, Environment Ministers recommended that OECD nations should pursue a strategy that includes the use of economic instruments to improve the integration of economic and environmental decision-making. The OECD Council subsequently adopted a recommendation on economic instruments for environmental protection and emphasized the need to use these instruments to a greater extent to improve the allocation and efficient use of natural and environmental resources, and that further agreement be sought at the international level on the use of economic instruments for solving regional or global problems and to ensure sustainable development. See OECD, *Environment policy: how to apply economic instruments*. Paris, 1991.

34. Stephan Schmidheiny with the Business Council for Sustainable Development, *Changing Course*, Cambridge and London: MIT Press, 1992, p.23.

35. Emission charges are frequently designed to encourage the control of water, waste and noise pollution. Such charges are used in France, Italy, Germany and the Netherlands. Emission charges are less common in the control of air pollution where charges have usually been set too low with not much effect on air quality. In the case of waste pollution control, there is considerable experience in municipal and industrial wastes in several developed countries such as Austria, Belgium, the Netherlands, or the United States.

36. In Malaysia, where the oil palm industry is a major polluter, a pollution charge on effluent from the processing mills has been in place since July 1988. (See Economic and Social Commission on Asia and the Pacific (ESCAP), (1992), op. cit.). Also, taxes on air and water pollution are in the process of being implemented in some developing countries, such as Thailand. In Taiwan. Prov. of China, the government passed in 1991 an air pollution control act which allows for a system of emission charges. (See O'Connor, D., "The use of economic instruments in environmental management: the experience of East Asia", in OECD, *Economic instruments for environmental management in developing countries*, op. cit.)

37. One of the most effective product charges is the surtax on oil excise duties applied in the Netherlands, since it internalizes environmental costs through the energy required to process inputs, and is administratively efficient. Other examples are the world's first carbon tax, introduced by Sweden in 1991, as well as other energy and transportation sector taxes. The tax on fertilizer introduced by Finland already in 1979, to discourage pollution caused by phosphorous and nitrogen loads is another example. See Pearce, D.W., and J. J. Warford. *World Without End*. Washington,: Oxford University Press, 1993, as well as OECD, (1993), op. cit. With regard to waste disposal, product charges on lubricant oils (following a 1975 EC directive requiring the recycling of waste oils) have been effectively implemented and have been reported to be useful as an internalization mechanism (see chapter 7 in ibid).

38. In Thailand, as from 1991, a tax on leaded gasoline has been used to finance a subsidy for unleaded gasoline.

39. The adjustment from market to full cost price is achieved by adding a tax which equates to the social welfare effects of the externality.

40. If the aim is to get an exactly correct tax, difficulties arise that have to be solved through sequential steps. First, the extra benefit society gains from an extra unit of the externality has to be calculated (marginal social benefit schedule for the externality). Secondly, the cost curve attributable to the externality should be constructed (marginal social cost). Thirdly, the level of externality at which the marginal social cost equals the marginal social benefit should be identified. Finally, identification of the level of the tax corresponding to the optimal level of the externality has also to be undertaken. For a discussion of these steps, see Pearce, D.W., and Turner, R.K., (1991), chapter 6, op. cit.

41. It must be borne in mind, of course, that these world prices themselves do not reflect all the relevant costs, and are affected by the very subsidies which are here criticised. This makes the argument against subsidies even stronger.

42. Pesticide subsidies in Indonesia, fertilizer subsidies in the Republic of Korea, subsidized energy, mainly in petroleum exporting developing countries, as well as in Thailand (lignite), Republic of Korea and Taiwan, Province of China (energy prices) or low water charge in most countries, causing overwatering and salinization problems (India, Pakistan) are just some illustrative examples. See OECD, (1993), op. cit. and Pearce and Warford.

(1993), op. cit.

43. The description of marketable permits and market creation mechanisms has beendealt with extensively in recent OECD publications.

44. Tientenberg, T.H. develops a very interesting discussion about the emission trading case. See Tietenberg, T.H., op. cit. in Markandya, A. and S. Richardson (1992), op. cit.

45. At the State level, the United States has also applied a marketable permit system to address problems with water quality (State of Wisconsin). In addition, both Germany and the Netherlands are studying and debating implementation of similar instruments for water pollution abatement. See OECD, (1993), op. cit., chapter 3.

46. The secretariat has conducted a series of studies on this matter, using extra-budgetary funds contributed by certain governments. The first set of results of these studies has been published in *Combating global warming*, UNCTAD/RDP/DFP/1, 1992. Further studies are underway.

47. In the case of a deposit-refund system for beverage containers, the internalization of the externality is achieved by giving bottle users an incentive to return the bottle for re-use or recycling, so that the deposit can be refunded. The deposit-refund system can be allocatively efficient and similar to a "Pigovian tax" (i.e., emission or product charges as discussed above), if the deposit is set at a level equal to the marginal social damage caused by the bottle not being returned.

48. Since 1988, the Republic of Korea has operated a deposit-refund system on food containers, tyres, batteries, lubricants, pesticide containers and plastics. See London Economics, "The potential for using market instruments for pollution control in developing countries", London, 1992. In the case of batteries with a high content of mercury and cadmium, Denmark, Finland, Norway and Sweden are examining the possible implementation of such systems.

49. See *Combating global warming*, op. cit., the monograph prepared by UNCTAD on this subject.

50. Exclusive because costs and benefits should accrue exclusively to the owner; transferable (from one owner to the other); and secure (from involuntary seizure by neighbours). See OECD, (1993), op. cit.

51. In Bangladesh, inland fishing grounds were auctioned to the highest bidder. However, as the auctions were annual, the short license period, with no assured renewal, led the owners to maximize revenue by allowing entry to as many fishermen as possible, and charging for entry. Hence overfishing (intertemporal externality) occurred. See Siddiqui, D., "Licensing versus leasing systems for government owned fisheries (Jalmahals) in Bangladesh". In Aguero, M. et al. (eds.), *Inland Fisheries Management in Bangladesh*, ILLARM, Manila, 1989.

52. Thus, the European Community is proposing that with respect to transport of oil by sea not only the shipowner but also the owner of the cargo should be financially liable for damage which the oil might cause, the aim being to incite the owner of the oil to choose reliable ships.(see *Le Courrier* (Geneva) 27 January 1993).

53. An extreme perverse example was that of Brazil, where it has been at times the case that it was necessary to burn down the forest in order to claim it. (See T. Sterner, in *Economic Instruments for Environmental Management in Developing Countries*, OECD 1993, p.57.)

54. As argued recently by Ostrom, the failure to explain how indigenous people manage to use certain natural resources sustainably invalidates the assumption that privatization or state control are the only panacea for governing the commons. See Ostrom, E., *Governing the commons*. Cambridge: Cambridge University Press, 1990.

55. Australia, the United Kingdom, Norway, Sweden, Finland and the United States have been reported in various OECD sources to apply variations of performance bonds and non-compliance fees. In Malaysia, performance bonds were introduced in the 1960s for mine rehabilitation. The amounts required ranged from US$1,000 per acre in Jahore, to US$5,000 in Kuala Lumpur and Selengor. See Pearce, D.W., (1993), op.cit.

56. For example, and as regards education and training programmes, German development cooperation institutions are already developing two training programmes with the Industrial Board and the Ministry responsible for environmental issues in Chile. As a basis for applying economic instruments to further improve environmental quality, cost-recovery for waste water management is being addressed. See Hortsmann, K., "Economic instruments for environmental protection, status and trends in German Development Assistance", for the Federal Ministry for Economic Cooperation (BMZ) of Germany, in OECD, (1993), op. cit., chapter 4.

57. Rio Principle 10 reads as follows: "Environmental issues are best handled with the participation of all concerned citizens, at the relevant level. At the national level, each individual shall have appropriate access to information concerning the environment that is held by public authorities, including information on hazardous materials and activities in their communities, and the opportunity to participate in decision-making processes. States shall facilitate and encourage public awareness and participation by making information widely available. Effective access to judicial and administrative proceedings, including redress and remedy, shall be provided."

58. See Tobey, J.A., "The Integration of Economic and Environmental Policies in Natural Resource Management: Views from the OECD", paper prepared for an international expert meeting on strategies for sustainable resource management and resource use, Neorwijk, The Netherlands, June 3-4, 1993.

59. Schmidheiny, op. cit., p.23.

60. E.g. in Article 6 of the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal, in Article 1 of the London Guidelines for the Exchange of Information on Chemicals in International Trade (Decision 15/30 of the Governing Council of UNEP, 25 May 1989) or in Article 9 of the International Code of Conduct on the Distribution and Use of Pesticides (as adopted by the 25th Session of the FAO Conference in November 1989).

61. For an interesting approach on the case of Africa, see Lange, G.M., and Duchin, F., "Integrated environmental-economic accounting, natural resource accounts, and natural resource management in Africa. Draft prepared for the Bureau for Africa, ARTS/FARA as part of a study supported by the Environmental Policy Analysis and Training Project of USAID. Institute for Economic Analysis, New York University, New York, May 1993.

62. Rio Principle 13 reads as follows: "States shall develop national law regarding liability and compensation for the victims of pollution and other environmental damage. States shall also cooperate in an expeditious and more determined manner to develop further international law regarding liability and compensation for adverse effects of environmental damage caused by activities within their jurisdiction or control to areas beyond their jurisdiction."

63. Rio Principle 15 reads as follows: "In order to protect the environment, the precautionary approach shall be widely applied by States according to their capabilities. Where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation."

64. See e.g. "Responsible Care, A chemical industry commitment to improve performance in health, safety and the environment", CEFIC, European Chemical Industry Council, Brussels, document CEFIC 5/1993.

65. Adopted in July 1986 for recommendation to members.

66. As of October 1993.

67. In 1974, a Compensation Fund was created in Japan by the "Pollution-Related Health Damage Compensation Law" to compensate sufferers of pollution-caused illnesses. In the Republic of Korea, an Environmental Pollution Prevention Fund is ifunctioning, financed by government funds, as well as by fines or charges levied on polluters exceeding emission standards. An Environmental Fund was launched in Thailand, in 1991.

68. The first three of these criteria are suggested in OECD, "Guidelines and Considerations for the Use of Economic Instruments in Environmental Policy", Annex to the Recommendation of the Council on the Use of Economic Instruments in Environmental Policy, adopted by the OECD Council at its 750th Session on 31st January 1991.

69. Rio Principle 7 reads as follows: "States shall cooperate in a spirit of global partnership to conserve, protect and restore the health and integrity of the Earth's ecosystem. In view of the different contributions to global environmental degradation, States have common but differentiated responsibilities. The developed countries acknowledge the responsibility that they bear in the international pursuit of sustainable development in view of the pressures their societies place on the global environment and of the technologies and financial resources they command."

70. Rio Principle 8 reads as follows: "To achieve sustainable development and a higher quality of life for all people, States should reduce and eliminate unsustainable patterns of production and consumption and promote appropriate demographic policies."

71. The stages approach is based on elaboration from Panayotou, T., "Economic incentives for environmental management in developing countries", in OECD, (1993), op. cit., chapter 2, as well as other recent OECD sources.

72. See Demsetz, H., "Towards a theory of property rights", *American Economic Review*, Vol. 57, 1967. For a very pertinent discussion on "Demsetz views" and the potential gains to cooperation see, Barrett, S., "The problem of global environmental protection", *Oxford Review of Economic Policy*, Vol. 6, No. 1, 1990.

73. Other variants are debt-for-sustainable-development-swaps whereby debt is swapped for a more general agreement to undertake actions beneficial to the environment. In addition, and for a discussion on ways of combining debt reduction with halting deforestation, see Bauer, A., and Illing, G., "Debt-for-nature-swaps: axing the debt instead of the forests", *Intereconomics*, January/February 1992.

74. The World Heritage Convention is unique among international environmental agreements for incorporating side payments. The Convention established a World Heritage Fund that is used to help protect mutual

environments of "outstanding universal value". See Barrett, S., (1990), ibid. See also WIDER, "The environmentand emerging development issues", Study Group Series No. 7 (1991), pp.15 ff.

75. By the time this paper is available to governments, the final shape of the GEF should be known. At the time of writing (late 1993), there was considerable controversy about several facets of the GEF as constituted in its initial "pilot version". In particular, many observers were posing questions about GEF's decision-making process; its institutional "home"; its relationship to the Commission on Sustainable Development; the meaning and implications of the "incremental costs" it is intended to finance; and whether the climate change and biodiversity conventions should be financed by GEF or have their own separate facilities. See *Developing Countries and GEF: For a Strategy of the South*. Geneva: South Centre, May 1993.

76. It can be constrained by problems of ownership, monitoring and measurement. In addition, the system is relevant primarily in terms of developed country commitments; developing countries are mainly involved in responding to proposals. It is unlikely to prove satisfactory in the long term.

77. This mechanism may also be applicable to other Conventions such as the Biodiversity Convention, although the precise equity and efficiency implications need to be more thoroughly looked at. For a very interesting proposal on this issue see, Environmental Defense Fund, "Sustainable development through trade in environmental commodities", New York, 1993.

78. See *Combating global warming*, op. cit., the monograoh prepared by UNCTAD on this subject.

79. E.g., as espoused by the OECD: see *Taxation and the environment: complementary policies*, OECD 1993, p.69.

80. *ibid.*

81. See Chichilnisky, G., and G.M. Heal, "Market instruments for environmental policy", Columbia University, September 1993; and Hoel, M., "Efficient international agreements for CO_2 control", *Energy Journal*, 12:2, 1991. See also for a general discussion on this issue, Grubb, M., "Options for an international agreement", in UNCTAD/RDP/DFP/1, (1992), op. cit.

82. The strong negative impact of pesticides on biodiversity, increasing pest resistance or producing direct health hazards, is already well known, and determinants inherent or external to the production and processing of commodities have been identified as well in recent research. In addition, pollution problems of mineral exports, forest clearance for croplands and grasslands, and fish catch levels which sometimes exceed regeneration thresholds tend to be significant.

83. The authors of the study suggest the use of the "Non-Polluter Gets Paid Principle" to compensate commodity exporting countries who are currently subsidizing consumers by freely exporting often irreplaceable natural capital. See Linneman, H., Kox, H.L.M., van der Tak, C.M., and A.P.M. de Vries, "Preliminary conditions for international commodity-related environmental agreements. Results of a pre-feasibility study". Research Project on International Commodity-Related Environmental Agreements (ICREA), Faculty of Economics and Econometrics, Free University of Amsterdam, January 1993.

84. Note that this does not refer to low prices caused by prevailing supply and demand conditions on the markets for commodities, which is an entirely separate issue.

85. In contrast with what happens with aid for development, in which if no mechanisms for internalization are devised, such aid results in many cases in the perpetration of the externalization of external costs. See Taylor, R., "Positive incentives, sustainable commodity production and the OECD. A constructive approach to the integration of trade, environment and development policies", Paper presented at the OECD's Trade and Environment Seminar, 30 June 1993.

86. See, Pearce, D.W., (1993), op. cit., pp.44.

87. In the late 1980's, about half of all developing countries' exports still comprised fuel, minerals and other primary commodities. Thus, trade distortions reduce developing countries' export revenue, and for this reason, the funds available to introduce environmentally improved methods of production. See Repetto, R., (1993), op. cit.

88. This is, however, by no means a certain outcome of such internalization: the dynamic effects of incentives for internalization and the use of "clean technologies" may result in cost savings, rather than increases. A vast industry has been spawned by the search for technologies which would have these characteristics.

89. See the views cited in "UNCTAD's contribution within its mandate, to sustainable development: trade and the environment. Trends in the field of trade and environment in the framework of international cooperation". Report by the UNCTAD secretariat, TD/B/40(1)/6, August 1993.

90. For more details about the school of thought which in the United States supports the use of countervailing duties to achieve environmental goals, see Congress of the United States, "Trade and environment, conflicts and opportunities", 1992, p.92. See as well Housman, R.F., and D.J. Zaelke, "Making trade and environmental policies mutually reinforcing: forging competitive sustainability", mimeo, Center for International Environmental Law (CIEL), Washington, February 1993.

91. For a complete discussion on the inappropriateness of the use of trade restrictive measures for environmental purposes see UNCTAD, TD/B/40(1)/6, op.cit., pp.22-24, August 1993. See also Repetto, R., (1993), op.cit.

92. The concept of environmentally-sound technologies (ESTs) is a broad one. In general terms, ESTs protect the environment, are less polluting, use all resources in a more sustainable manner, recycle more of their wastes and products and handle residual wastes in a more acceptable manner than the technologies for which they were substitutes. See UNCED. *Agenda 21*. Geneva: United Nations, 1992, p. 2.

93. Under the framework convention on climate change, the parties are committed to "promote and cooperate in the development, application and diffusion, including transfer, of technologies, practices and processes that control, reduce or prevent anthropogenic emissions of greenhouse gases" (Article 4). The Convention on Biological Diversity is even more explicit, stating that technologies relevant to the conservation and sustainable use of genetic resources "shall be provided and/or facilitated under fair and most favourable terms, including on concessional and preferential terms when mutually agreed". It also states that transfer of patent protected technology will be "consistent with the adequate and effective protection of property rights.

94. Many technologies for recycling and waste recovery reduce the raw materials requirement and lead, as well, to the production of profitable by-products. An illustration is the case of the REFIMET mine in Chile, which has developed a successful process to clean arsenic-rich concentrates. The

process is so successful that in addition to processing Chilean ores, REFIMET imports concentrates from the Philippines and Greece. An increasing proportion of this by-product, arsenic trioxide, is being exported to the United States at a profit. See Warhurst, A., "Environmental degradation from mining and mineral processing in developing countries: corporate responses and national policies", OECD Development Center, 1993.

95. In the case of commodities, the price is a small part of the total retail price of the commodity, a fact which may induce many vertically integrated producers to absorb the environmental premium with little or no price rise to consumers.

96. In a recent study, Pearce reports how several brands of coffee are now being sold where the producers receive higher than world market prices, but the retail price remains competitive with other coffee brands. These schemes include Max Havelaar in The Netherlands, and Cafedirect in the United Kingdom. See Pearce, D.W., (1993), op. cit., pp. 56.

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TRADE POLICIES, STRUCTURAL ADJUSTMENT AND ECONOMIC REFORM: INCREASED PARTICIPATION IN INTERNATIONAL TRADE IN GOODS AND SERVICES BY DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION: SOME PROBLEMS AND OPPORTUNITIES

Report by the UNCTAD secretariat

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ABBREVIATIONS

CAP	Common Agricultural Policy of the European Union
CEECT	Central and Eastern European countries in transition
CEFTA	Central European Free Trade Area
CIS	Commonwealth of Independent States
CMEA	Council for Mutual Economic Assistance
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
FDI	foreign direct investment
FSU	former Soviet Union
GATT	General Agreement on Tariffs and Trade
GSP	generalized system of preferences
PHARE	Poland-Hungary Assistance for the Reconstruction of the Economy
TACIS	Programme of Technical Assistance to the Commonwealth of Independent States
TNCs	transnational corporations
VERs	voluntary export restrictions
WTO	World Trade Organization

INTRODUCTION

(i) At its eighth session, the United Nations Conference on Trade and Development called (in paragraph 63 (1) of the Cartagena Commitment) for mutually supportive efforts at national and international levels to ensure enhanced participation in the world economy of developing countries, as well as countries undergoing the process of transition to market economies. In paragraph 129, the Conference specifically invites member States to support the process of transition to a market economy and liberalize their trade regimes. It also calls upon UNCTAD to identify the opportunities resulting from the above developments for the mutual benefit of developing countries and individual economies in transition, notably through technical assistance. The Trade and Development Board is requested to periodically assess the above process.

(ii) In the light of the above and on the basis of its work programme for 1992-1995, the Board, at the first part of its fortieth session, decided to include in the provisional agenda for the second part of the same session, under item 2, the topic: "Increased participation in international trade in goods and services by developing countries and economies in transition: some problems and opportunities."

(iii) Thus far, the Trade and Development Board has considered, under the general agenda item of "Trade policies, structural adjustment and economic reform" discussed at the second part of its thirty-ninth session the issues relating to economic and trade policy reforms in developing countries and the international support required. The second part of the fortieth session will provide the opportunity to consider jointly the issues involved in increasing the participation of developing countries and of the economies in transition in international trade. Furthermore, the tentative work programme for the Trade and Development Board foresees for the spring session of 1995 a third part to the discussions on trade policies, structural adjustment and economic reform, focusing on "Developments relating to structural adjustment policies in developed countries and their implications".

(iv) This report has been prepared to facilitate the Board's deliberations on the topic before it at the second part of its fortieth session. Chapter I deals with selected issues encountered by developing countries and economies in transition with respect to their increased participation in international trade. Chapter II focuses on problems encountered by economies in transition in their mutual trade and economic cooperation. Chapter III deals with trade and investment cooperation between economies in transition and developing countries, measures to stimulate its expansion and international support required.

CONCLUSIONS AND POSSIBLE AREAS FOR INTERNATIONAL COOPERATION

(v) There exists a broad consensus within UNCTAD that the trade policy reforms under way in developing countries require complementary international support. Substantially improved market access is needed to act as a counterpart to the opening of their economies. Increased flows of investments, technologies, managerial skills and financial resources are required to strengthen their supply capabilities and competitiveness on world and domestic markets. While the implementation of the Uruguay Round results will be a major step forward for providing a more stable multilateral trading framework, trade barriers affecting their major export products, i.e. agricultural products, processed food, clothing and textiles, will remain high for a long period ahead. Accordingly, the conclusion of the Uruguay Round needs to be complemented by a substantial improvement of the generalized system of preferences. The Special Committee on Preferences should take early action to stabilize, improve and extend the benefits of the GSP scheme in favour of developing countries' exports.

(vi) Special efforts need to be made to liberalize imports of all types of export products of least developed and African countries, whose preferential market access has been substantially eroded by the rapidly widening scope of regional integration among developed countries and multilateral trade liberalization.

(vii) The Visegrad countries (Czech Republic, Hungary, Poland and Slovakia), Bulgaria and Romania have progressed considerably with their trade policy reforms, their integration into the multilateral trading system, and the establishment of closer economic ties with Western European countries. The Baltic States and most CIS countries are, however, still at the beginning of this process. Major efforts are still needed to put into place or complete an adequate trade policy and financial framework for its conduct of international trade; to revive and expand trade and investment cooperation amongst economies in transition and with developing countries, as traditional patterns have collapsed; and to modernize and rationalize the supply and export capacities of the countries concerned, as well as their infrastructure and services.[1]

(viii) The transition process can be accelerated and strengthened by international support, which should take the form of long-term programmes. Technical support programmes in the foreign trade sector should be intensified. Special attention should be given to the particular needs of the weaker economies in transition amongst the CIS States and in South-East Europe. UNCTAD's substantive work and technical cooperation could be useful in such fields as the strengthening of export support policies and instruments and enhancing of capacities for international trade negotiations; design of investment policies and support for negotiations with foreign investment partners; training of enterprise staff for trading in international commodity markets; streamlining of customs administration and trade procedures; and human resource development.

(ix) The most effective forms of international support, in particular by developed countries, for the transition to market economies would be an accelerated opening of their markets for exports of goods and services from economies in transition, as well as the encouragement of their firms to invest in those countries, inter alia through investment financing and risk insurance schemes.

(x) Negotiations on GATT membership and the renegotiation of the special protocols of accession on the basis of the Uruguay Round results should be fully supported by the international community. Economies in transition should be treated as normal trading partners, and trade relations with them should be based effectively on unconditional MFN treatment and the elimination of all residual elements of past discriminatory trade regimes applied against these countries.

(xi) Discriminatory treatment applied against certain developing countries such as China, Viet Nam and Mongolia with regard to the application of GATT rules, quantitative restrictions and tariffs should be progressively removed, to the extent that their economic and trade policy reforms progress and the introduction of enterprise economy and price deregulation advance. Initiatives of such countries for closer integration into the multilateral trading system should be encouraged.

(xii) The revival and expansion of mutual trade and investment relations amongst economies in transition should attract high priority, as its collapse was one of the main factors responsible for the decline in their GDP. Large opportunities can be opened up by the creation of new relationships between autonomous enterprises based on market principles and instruments. The various new regional integration initiatives within CEFTA, the Baltic States and CIS merit full international support.

(xiii) A substantial potential for expansion of trade between developing countries and economies in transition exists in the medium-term, when Central and Eastern European countries will reach a trade intensity with developing countries similar to that reached by Western European countries now (see chapter III). However, thus far, the disruption of traditional links between major developing country suppliers and CIS States has more than offset the incipient recovery of imports of some Central European countries from developing countries.

(xiv) A more widespread revival of mutual trade and the exploitation of potential opportunities will need the progressive establishment of a framework of national policies and cooperative measures: (a) liberal import and export policies should be applied to mutual trade: inter alia, all industrialized CIS States should apply GSP treatment to developing countries; developing countries should be exempt from increases in MFN duties through the stabilization of GSP rates; (b) trade financing and export risk guarantee schemes should cover trade with developing partners and economies in transition; (c) central banks and foreign trade banks of economies in transition should cooperate with their counterpart institutions to facilitate payments, trade and investment financing; (d) investment and technological cooperation should be fostered, including joint ventures for exports, through tax, financial and logistical government support measures, economic and investment cooperation agreements, double-taxation agreements and the like; (e) initiatives by chambers of commerce and industry, business associations and similar representative organizations of the business sector should be multiplied to stimulate enterprise-to-enterprise cooperation; (f) intergovernmental consultations with developing countries could be reinforced in appropriate cases by the assignment of trade counsellors.

(xv) International support and technical cooperation can make an important contribution to reviving trade and economic cooperation between economies in transition and developing countries and fostering the new potential. More specifically, technical cooperation by developed countries and international organizations would be particularly useful in such areas as:

(a) Provision of financing for mutual trade, for example through untying of aid for procurement in developing countries; in addition the feasibility of a special window with an existing multilateral development bank, such as EBRD or the World Bank, should be explored;

(b) PHARE, TACIS and similar programmes should be extended to trade and investment cooperation with developing countries;

(c) Concessional finance should be provided to mobilize technical expertise available in economies in transition for revitalizing cooperation with developing countries;

(d) The feasibility of an international co-financing facility for joint ventures between economies in transition and developing countries should be explored.

(xvi) UNCTAD can provide a forum for economies in transition, including the newly independent States, for the conduct of intergovernmental consultations on issues of trade and the external sector within its mandate. UNCTAD can further provide technical assistance in support of their negotiations for full integration of economies in transition into the international trading system, their mutual cooperation and integration, their trade and economic cooperation with developing countries and training as specified in the various sections of this report. Furthermore, various areas of UNCTAD's work programme could be of interest to economies in transition in their efforts to accelerate and strengthen their transformation process in such areas as trade, investment and technology policies, commodities, and the exchange of experience in respect of privatization.

Chapter I

PARTICIPATION IN INTERNATIONAL TRADE BY DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION: SELECTED ISSUES

A. Issues and problems faced by developing countries in their participation in international trade

1. By pursuing their structural adjustment and economic reform programmes, a large number of developing countries have turned resolutely towards the opening of their economies and an outward-oriented approach to development. Increased and diversified exports are expected to provide a motor for economic growth where liberalization of imports, coupled with improved attraction of foreign investment and technology transfers, is to spur international competitiveness and efficiency of production and improve allocation of resources.

2. Actual experiences regarding the success of outward-oriented policy strategies are, however, mixed.[2] Export growth and diversification have frequently remained below expectations, and progress in building and diversifying industrial export capacity has turned out to be a particularly difficult and long-term task. There is considerable evidence to show that the operation of supply-side reforms directed towards increased participation in the world economy requires longer time periods and substantial international support to yield significant improvements in trade, production and investment, in particular in medium- and low-income countries.

3. Major problems also persist with respect to market access. Developing countries' trade will have to be expanded and diversified on a global scale with developed countries, with economies in transition and among themselves. They need liberal market access for all their main exports, as well as stability and security of international trading conditions. Furthermore, the new dynamism in the formation and expansion of regional integration groupings around major trading nations has raised new concerns but also brought about new opportunities and challenges for developing countries' integration into international trade.[3] Yet another issue in the promotion of trade of developing countries is the need to take into account aspects of sustainable development within a framework of clear multilateral rules and without restricting market access.[4] Finally, the transformation of Central and Eastern European economies may imply short-term problems for developing countries, but opens up important new prospects for the medium-term (see chapter III).

1. Supply-side constraints and trade policy reforms

4. Despite a decade of intensive structural adjustment, economic reforms and trade liberalization in developing countries, severe supply-side constraints remain a prominent feature in the great majority of developing countries.[5] Inadequate investment funds, scarcity of human resources and insufficient technological capacities continue to be major bottlenecks which inhibit improvements in export potential and competitiveness.

5. The least developed countries, including many African economies, face particularly challenging supply-side constraints. Human skill development in these economies requires substantial external support. Moreover, the least developed countries are most in danger of suffering from technological marginalization. Much more needs to be learned about criteria for selecting in situ technology-related projects in countries with low incomes and an underdeveloped technology base.[6]

6. Policy experiences of rapidly growing exporters in East Asia suggest that high domestic saving and investment rates, an emphasis on educating and training the labour force, flexible labour markets and access to imported technology and production methods have been factors contributing to the success of these Asian economies on the supply side. The scope of government intervention through trade and industrial policies has varied among these countries, but evidence indicates that interventions broadly conformed to the market where success was observed.[7]

7. The Trade and Development Board has recognized the need for technical cooperation to assist in improving the design and implementation of trade policy reforms.[8] Such programmes should incorporate a social component and provide for an appropriate safety net. There is a consensus that the international community should support these efforts in developing countries, particularly the least developed, including through increased flows of financial resources and debt relief. The Board has further agreed that human resource development constitutes an essential component of strengthening international competitiveness. Furthermore, developed countries ought to provide on a larger scale incentives and assistance conducive to technology transfer and foreign direct investment in developing economies.

8. International support to facilitate the transfer of technology to developing countries could make use of market-based price incentives, in particular for the transfer of specific, critical technologies.[9] Moreover, joint ventures and industrial collaboration between enterprises in developed and developing countries should be promoted to enhance investment and transfer of technology, improve management and increase exports.[10] The Ad Hoc Working Group on the Expansion of Trading Opportunities for

Developing Countries is considering further ways to strengthen export supply capacities, as well as measures to improve market access.

2. Issues relating to market access

9. Developed country markets remain of pre-eminent importance for most developing countries. In spite of considerable efforts and progress in diversification of geographical trading patterns, developing countries as a group still rely on these markets for almost 60 per cent of their exports; this dependence exceeds 70 per cent for Latin American countries and 80 per cent for African countries.

10. While trade liberalization and outward-oriented trade policies have been common features in the recent international trade scene for many developing countries and economies in transition, there was little improvement with regard to these countries' access conditions to the markets of developed countries until the conclusion of the Uruguay Round. Protection of agricultural products, clothing, textiles, etc., has continued, while threats to revert to protectionism and managed trade have not totally disappeared. When developed countries followed a liberalization path, this was done in a cautious manner. Further, unilateralism and selective application of trade measures have remained a problem for developing country partners.

11. Some recent developments have given rise to new concerns for developing countries. In principle, the completion of the single market of the European Union called for the elimination of the remaining national quantitative restrictions applied by individual member countries (except for textiles and clothing). However, in a few highly important cases involving agricultural exports, new problems arose.[11] Furthermore, certain developing countries, including some which have undertaken major economic reforms and progressed towards market economies (such as Viet Nam, China and Mongolia) are still subjected by developed countries to discriminatory quantitative restrictions, tariffs and provisions with respect to dumping, subsidies and safeguards (see chapter I.B.2). Some developing countries remain subject to United States embargoes. For others, MFN treatment by the United States is conditional.

12. Anti-dumping and countervailing measures may be used to afford protection to domestic industries which suffer as a result of increased imports from more competitive sources. The annexed table 1 shows that the use of these measures has generally increased dramatically, as cases initiated almost trebled between 1990 and 1993. In more than half of the cases where anti-dumping action was initiated, no definitive anti-dumping duties were imposed: nonetheless, the initiation of investigations and provisional anti-

dumping duties leads to substantial harassment of exporters and might hamper trade substantially, even if the final conclusions of such investigations show that claims of dumping were not justified. The number of anti-dumping actions involving imports from developing countries has increased since 1991.

13. The implementation of the Uruguay Round results is expected to lead to an important liberalization of international trade. It will strengthen multilateral disciplines and impart greater security and stability of market access conditions, for example in connection with the application of safeguards and anti-dumping and countervailing measures. However, major product sectors of particular export importance to a majority of medium-sized and smaller developing countries will remain subject to high barriers for a long period ahead. This will be the case for clothing and textiles, where the phasing-out of quantitative restrictions will not lead to their final elimination for a decade; agricultural and food products, where tariffication will result in high rates in many cases; and a range of other sensitive products like shoes, leather products, and consumer electronics, where tariffs remain relatively high. Other major issues remain unresolved: internal barriers to market access, restrictive business practices, and environmentally motivated restrictive trade measures will require complementary international action to assure competitive market structures and improved market access.

14. Thus, the progress achieved by the Uruguay Round of Multilateral Trade Negotiations needs to be complemented by a profound improvement of the generalized system of preferences. The tariffication of quantitative restrictions should enable a significant extension of product coverage and compensate to some extent the erosion of preferences through the Uruguay Round and the spread of economic integration schemes. The reduction of tariffs for industrial products to low levels should enable a substantial simplification of the GSP schemes for such products, including the removal or harmonization of ex ante safeguards and ceilings, the reduction of remaining preferential duties to zero, and a substantial simplification of administrative provisions. Many restrictive criteria and procedures of GSP rules of origin should no longer be required at low duty levels.

B. Issues and problems encountered by economies in transition in their participation in international trade

1. Progress made in the transition process in trade and trade-related areas

15. The transition from centrally planned to market economies comprises a complex transformation of economic and social structures with many facets such as: decentralization of economic decision-making; a change in governments' role from direct

involvement in production and trade to macro-economic management and the elaboration of an appropriate legal and institutional framework; price-liberalization; privatization; financial liberalization; banking reforms; fiscal reforms; building of a social safety net; and trade policy reforms and the liberalization of imports and exports.[12] This report focuses on the trends of and issues arising from transition processes which are essentially related to trade and investment. As the transition processes in the various countries of Central and Eastern Europe started at different points in time and from different starting points with regard to their production and foreign trade structures and were pursued within the framework of different strategies, the progress achieved varies widely between countries. This differentiation amongst countries in transition is important for understanding the underlying processes and for the design of appropriate policy measures.

16. With regard to the external sector, the main progress achieved thus far includes a substantial opening of foreign trade and investment, profound changes in monetary and foreign exchange management and control and, in particular, the rapid transfer of decision-making on foreign trade, investment and prices from government institutions to fully autonomous enterprises. This internal transformation was accompanied by varying combinations of external strategies. All countries have taken initiatives to strengthen their integration into the multilateral trading framework and the various international organizations concerned with trade and financing. Visegrad countries have complemented their continuing efforts for full GATT integration[13] by a vigorous strategy of rapid and full-scale integration into the European Union, as well as trade liberalization within CEFTA.[14] Their example is being closely followed by Bulgaria, Romania, and the Baltic States. CIS States are only in the earlier stages of negotiating GATT membership or obtaining observer status. Russia is presently in an advanced stage of negotiations on an economic cooperation and partnership agreement with the European Union. A Joint Political Declaration on Partnership and Cooperation was agreed upon in December 1993 which sets out the main principles and measures for political, trade, economic and cultural cooperation as a basis for early finalization of the Agreement. CIS has laid major emphasis on mutual integration and the establishment of an economic union. Some of the Central Asian countries are pursuing actively the intensification of their economic relations with neighbouring developing countries and their groupings.

17. A striking change in all these economies is that, instead of a limited number of large, tightly controlled, monopolistic foreign trade organizations, there are now thousands of small, medium-size and large enterprises which decide autonomously on production and prices and carry out foreign trade operations on the basis of market conditions and prices. The emergence of a new and

autonomous small and medium-scale enterprise sector will radically change partners, channels and modalities and substantially enlarge the opportunities for foreign trade and international specialization.

18. A second area of progress has been the liberalization of exchange controls, foreign trade and investment from administrative barriers and largely also from quantitative controls, which are gradually being replaced by market-oriented trade policy instruments. Most advanced in this direction are the Visegrad countries, Bulgaria and Romania. Their principal trade policy instruments are customs tariffs, which frequently ranged between 5 and 15 per cent in 1992/1993. Substantially higher MFN rates (which may reach 20 to 40 per cent or more) are applied to agricultural products, clothing, textiles, some other consumer goods, and automobiles as well as tobacco products and alcoholic beverages. After initial liberalization at the start of the reforms in these countries, there has been a tendency to increase tariff protection again more recently. The average effectively applied MFN tariff in 1992/1993 was about 18 per cent in Poland,[15] 13 per cent in Hungary, 14 per cent in Romania, 18 per cent in Bulgaria and 6 per cent in the former Czechoslovakia, where imports also remained essentially free of quantitative restrictions. Some of these countries apply quantitative restrictions, licensing, variable levies and other non-tariff measures, in particular to imports of agricultural products, processed food, certain clothing and textiles, cars, etc.

19. In principle, in these countries the legal and institutional reorganization of foreign trade (investment, banking and related sectors) is far advanced, and many of the necessary market economy mechanisms are already installed and operational.

20. The Baltic States have made steady progress in their transition to market economies, in particular in the foreign trade sector. Imports have been largely freed from administrative regulations and quantitative restrictions and tariffs are relatively low, though certain exports remain subject to high tariffs, quotas and state monopolies. Their foreign trade strategies emphasize negotiation of GATT membership, mutual integration, and close cooperation with the Scandinavian countries through free trade area agreements.

21. Amongst the CIS countries, Russia is the most advanced in the area of trade policy reforms. A custom tariff has been introduced. MFN duties have been modified and presently range between 5 per cent and 30 per cent for most products. New regulations on quality and safety control and a substantially undervalued rouble exchange rate create additional protection. However, there are no quantitative restrictions on imports. In order to ensure domestic supplies, export quotas and tariffs are imposed on a range of

"strategic goods" like raw materials and energy products. Exports of these "strategic goods" are permitted only by specially authorized traders.[16] Ukrainian tariffs generally range between 10 and 20 per cent (with the exception of revenue duties). Imports are free from licensing and quantitative restrictions. Exports of several strategic commodities are subject to export tariffs, while exports of non-ferrous metals, petroleum and some other products are subject to export quotas and licensing.

22. Many of the other CIS countries are only now introducing their own national currencies and fully fledged Central Banks. Some basic institutional mechanisms of foreign trade are still missing; they have not yet introduced customs controls, tariffs and complete foreign trade legislation or are only in the process of doing so. Many of them lack basic instruments to support foreign trade by enterprises, such as financial institutions, or training of export management in foreign trade and investment.

23. The trade and foreign exchange regimes emerging in Central and Eastern European countries should be kept open to imports from all potential trading partners. Customs tariffs should be maintained only at moderate rates, and quantitative import and export restrictions should be progressively relaxed and ultimately removed. Towards this end and in order to improve their capacity to resist protectionist pressures from domestic enterprises and foreign investors, economies in transition should consider the recommendation of the Cartagena Commitment (paragraph 132) to establish transparent national mechanisms to evaluate protective, safeguard and anti-dumping measures. Such national mechanisms should assess the economic justification for these measures and their potential effects for the domestic economy as a whole, as well as evaluate their implications for foreign trading partners, in particular developing countries. The UNCTAD secretariat could provide information on the working of such mechanisms and technical advisory services for their establishment, if required.

2. Major issues and concerns

24. A major continuing problem in the foreign trade sector is that the transformation process has not yet led to vigorous growth of overall foreign trade and investment. The disruption of traditional trade continues to affect adversely production and employment in many of the countries in transition.

25. Even Visegrad countries, which have achieved considerable success in reorienting their external trade and investment relations, have suffered from a perceptible decline in their exports in real terms since 1988. Even in nominal terms, their global exports have not yet again reached their 1988 level. These meagre overall results conceal, however, a substantial transformation of their foreign trade patterns; most of their

trade is now conducted on competitive terms with developed and developing market economies. The major dynamic segment has been the growth of trade with industrialized countries: exports expanded vigorously by 60 per cent between 1989 and 1992 and the share of these markets rose from 40 to 67 per cent.

26. Other countries in transition, and in particular the CIS States, have also felt the serious negative impact of their foreign trade sector on production and employment. According to estimates, foreign exports and imports of the former Soviet Union about halved between 1989 and 1992 (see annex table 3).

27. A vital common concern of economies in transition is that, in spite of considerable improvements in market access, major barriers continue to exist with regard to their main export products in the major developed country markets, and new barriers are being built up by selective application of quotas, VERs and anti-dumping and countervailing measures where their exports are starting to expand (see section 2 below).

28. This issue of market barriers confronted by major exports is closely linked with problems related to the production structure of these countries and their narrow export supply capacities. The modernization, conversion and rationalization of production is in most economies in transition only beginning. Considerable efforts are still required to adjust products to make them competitive in terms of quality, standard, design and price on the international market. The present supply of export products has not substantially changed in relation to previous patterns. This is particularly the case in CIS countries. In 1992, half of their exports to developed countries, which are frequently used as an indicator for international competitiveness, consisted of energy. Other important export products included non-ferrous metals (copper, aluminium, silver), steel, chemical fertilizers, uranium, fishery products and basic commodities (such as cotton, diamonds, etc.). Some of these exports are growing. In addition, such products as heavy electrical machinery, as well as cars and components, are also rapidly gaining ground on Western markets. However, exports of most Central Asian countries are particularly highly concentrated on a few basic commodities, such as cotton or metals, and these countries face the most pronounced need for new investment in processing capacities and the diversification of their export products.[17] As compared to CIS, the export success of Visegrad countries in developed countries' markets is more diversified: clothing exports (including an important processing traffic), metal manufactures, cement, wood, leather manufactures and similar products accounted for about two-thirds of the total export increase over the past four years. However, dynamism was even greater for certain machines, heavy electrical equipment and vehicles, which now account for about one-sixth of total exports from Visegrad countries (and have overtaken agricultural products,

with their 10 per cent share). In spite of these shifts, the bulk of the exports from economies in transition are in sensitive sectors of the developed countries' economies, i.e. sectors where demand growth is slow, over-capacities are large, and unemployment high. Protectionist resistance against a more expeditious opening of markets is, therefore, strong.

29. In some of these sectors, the increased export supplies of economies in transition will also compete with those of developing countries, which are also major exporters of base metals, fertilizers, cotton, clothing, etc. Such effects may be reinforced where economies in transition enjoy market access advantages over developing countries in the framework of regional preferential arrangements with major developed countries.[18]

30. These prospects may, however, change in the medium and longer run, as the structural transformation of Central and Eastern European countries brings their technological capacities, high skill levels and closeness to European Union markets fully into play. Diversification of export patterns into more processed, higher-technology and higher-quality products is likely to advance.[19]

31. Important institutional mechanisms needed to help strengthen export supply capabilities are frequently still missing. In this connection, the reform of the banking sector is crucial for commercial transactions, trade and investment finance. Government-supported foreign trade banks, export credit guarantee schemes, investment banks and investment advisory services for potentially interested domestic and foreign investors are not yet functioning effectively in some of the countries in transition, in particular CIS countries, including Russia. Their scope of action is frequently limited in others, such as the Visegrad countries.[20]

32. Large amounts of financial and technical assistance and a vigorous promotion of foreign direct investment formed part of the external support originally considered to be required for successful transformation.[21] Little of the financial aid has actually been forthcoming, apart from debt reduction and in some specific sectors, such as energy and environmental projects.[22] Substantial technical assistance has, however, been effectively provided under various international, regional and bilateral programmes, including PHARE, TACIS and corresponding EFTA programmes, in support of the building up of market mechanisms, sectoral reforms and training.[23]

33. Various UNCTAD activities could also be of interest in the context of the strengthening of the external sector. UNCTAD's Programme on Transnational Corporations provides technical advisory services to individual countries in transition for the reform of their foreign investment policies, incentives and accounting

standards, as well as for their relations with the TNCs. This assistance has included, inter alia, programmes to strengthen the capacities of specialized research and development centres for marketing their technologies and for creating new linkages with TNCs for that purpose. A further important component has consisted of advisory services for economies in transition in the petroleum and mineral sectors for the modernization of their investment policies and legislation and the review and evaluation of specific investment contracts.[24] Furthermore, UNCTAD can assist in the formulation of foreign trade policies and instruments, as well as in the strengthening of capacities for international trade negotiations, including negotiations on accession to GATT. In the field of commodities, UNCTAD can provide technical advice and training in specialized commodity trading and its financing. Furthermore, UNCTAD's programme for streamlining of trade and customs procedures, customs computerization, trade information and the establishment of trade points can also be extended to interested economies in transition. Other existing programmes for human resource development, including TRAINFORTRADE's training programme for enterprise management staff and government officials, could also be extended and adapted to specific country needs, with as the courses on trade policies, trading with the European Union or trade and environment. More generally, UNCTAD's intergovernmental consultations and research could be of interest to economies in transition in various areas relevant to the transition process, such as: the functioning of commodity markets and risk management, as well as policies for commodity processing and diversification; the relationship between investment and technology and its financing; or the exchange of experience of member States with privatization.

34. Foreign direct investment in productive sectors has so far been limited. Estimates for FDI flows to Central and Eastern European countries show a substantial rise from about US$300 million in 1990 to US$2.4 billion in 1991 and US$2.7 billion in 1992.[25] Nevertheless, these amounts remained far behind the estimated needs of the transformation process. Thus far, FDI has taken on a major dimension only in Hungary (accounting alone for about 1.5 billion dollars p.a.) and to a lesser extent more recently in Poland. Meanwhile, the number of new commitments and registrations has increased rapidly since the beginning of 1993 in Romania and CIS, in particular in the petroleum and mineral sectors. Accelerated growth of foreign investment registrations has also continued in the Baltic States.[26] Even taking these recent trends into account, it would appear that up to now fears of competition and crowding out of FDI in developing countries have not been substantiated. FDI in economies in transition represents only a small fraction of worldwide FDI and remains small in comparison with FDI in developing countries. Furthermore, the latter has been rapidly growing in recent years (to a level of US$38 billion in 1992).

35. FDI remains clearly insufficient in comparison with the role which it is expected to play in the rationalization and technological upgrading of the economies in transition. This is also true for the reform processes of many smaller and medium-sized developing countries. As a complement to continued reforms by host countries, developed countries should also take measures to encourage FDI by their companies through financial and fiscal measures and investment risk guarantee schemes.

3. The integration of economies in transition into the international trading system

36. When countries in transition began transformation of their economies, their trade faced highly restrictive import and export regimes in major developed countries. These regimes discriminated against trade in various ways, including denial by a major trading country of unconditional most-favoured-nation treatment, even to some Central and Eastern European countries which had become contracting parties to GATT. As a result of a substantial improvement in trade regimes, most countries in transition are now granted MFN treatment by major trading countries, although the United States still differentiates between individual countries in transition in terms of granting them permanent or fixed-term MFN. In November 1993, members of the Coordinating Committee for Multilateral Export Controls (COCOM) announced their decision to terminate the activities of this body no later than 31 March 1994 and to replace it with a new organization that would include economies in transition and other countries.[27]

37. Developed countries have further taken measures to open their markets in favour of countries in transition at the MFN level or on a mutual basis, within Europe Agreements and EFTA Free Trade Agreements, and this has resulted in tariff reductions and some liberalization of several quantitative restrictions. Some of the economies in transition are receiving GSP treatment. This is, for example, the case of the Russian Federation, the other CIS States and the Baltic States vis-a-vis the European Union, some EFTA countries and Canada, as well as of the Visegrad countries, Bulgaria and the Russian Federation vis-a-vis the United States in the United States. However, some of the relatively less advanced Central Asian Republics frequently do not enjoy GSP benefits, for example in the United States,[28] the Scandinavian countries and Japan. For its part, Albania is not a GSP beneficiary in Sweden, Japan and the United States.

38. In spite of progress achieved, economies in transition still face a number of non-tariff measures, including levies and quantitative restrictions, in major markets for agricultural products, textiles, clothing, and other industrial exports. Some quantitative restrictions and special import procedures are specially targeted at them. In the European Union special national

restrictions of this type remain on a number of products from CIS countries (as well as such developing countries as China, Viet Nam and Mongolia), though their phasing-out is expected within the Single Market.[29] The European Union also introduced new selective quantitative restrictions at the Community level on imports of steel, aluminium and fertilizers from CIS States, as well as some VERs for products originating from Europe Agreement Partners.[30]

39. Furthermore, other residual elements of trade regimes previously applied to imports from these countries have continued to apply until now and remain an important obstacles to the countries' integration into the international trading system, including:

(a) Selective (bilateral) safeguard clauses, which enable emergency safeguard action to prevent injury to domestic producers to be applied against imports from only the country concerned and not to all other suppliers as required by Article XIX of GATT.[31] In addition, these clauses contain criteria for such actions weaker than those required by Article XIX of GATT and applied with respect to market-economy countries;[32]

(b) Special criteria for the imposition of anti-dumping and countervailing measures, based on prices in third countries with market economies or constructed values or even on domestic prices in the importing country of like products.[33] In particular, anti-dumping measures are amongst the most frequent access barriers which exporters from economies in transition encounter on their major markets (see annex table 4);

(c) Exceptions to GATT rules; when countries in transition became contracting parties to GATT, their trading partners obtained legal cover to treat them differently through inclusion of special conditions in their respective protocols of accession, including selective safeguard clauses, some form of import commitment and special surveillance mechanisms.

40. Most of the discriminatory elements of trade regimes still affecting economies in transition derived from perceptions in the major developed market-economy countries that import prices did not provide a sufficient yardstick in countries which, as defined in GATT, had "a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State".[34] The GATT contracting parties tended to consider that tariff concessions provided by several Central and Eastern European countries in their accession to GATT and during the Tokyo Round did not effectively improve market access. These concerns were reflected in special provisions of trade laws and in trade regulations designed to prevent "imports from the state-trading" or "non-market-economy" countries deemed to be market-disruptive. The situation has now changed substantially, as almost all countries in transition have

abolished the State monopoly on foreign trade and introduced market-based price mechanisms.

41. All individual economies in transition have been actively pursuing the objective of strengthening their integration into the international trading system both at the multilateral levels and within regional free trade and bilateral arrangements. Neither Czechoslovakia as a founding member of GATT, nor the countries which joined GATT later on, escaped from some or all the discriminatory trade regimes mentioned above. Poland, Romania and Hungary have requested the renegotiation of their protocols of accession with a view to obtaining full contracting party status. Other economies in transition have applied for accession to GATT: in the case of Bulgaria, negotiations are at an advanced stage; the applications of Albania, the Russian Federation, Belarus, Armenia, Moldova, Latvia and the Ukraine are more recent in date. Azerbaijan, Estonia, Kazakhstan, Kyrgyzstan, Lithuania and Turkmenistan obtained or applied for observer status in GATT in 1992-1993. Several countries in transition participated in the Uruguay Round or became associated with it.

42. The Final Act of the Uruguay Round and the modalities for the creation of a World Trade Organization embody progress in the treatment of economies in transition in the area of subsidies, but give rise to continued concerns in other areas. The Agreement on Subsidies and Countervailing Measures contains, in Article 29, positive and flexible provisions for signatories "in the process of transformation from a centrally-planned into a market, free enterprise economy" to apply programmes and measures necessary for such a transformation during a transitional period (including, in principle, prohibitive types of subsidies). Furthermore, the above-mentioned provisions which did not recognize export prices as a yardstick for the calculation of the amounts of estimated subsidies are no longer contained in the new Agreement. However, the new Anti-Dumping Code retains the earlier provisions relating to special provisions applying to so-called state-trading countries.

43. For countries in transition which are already GATT contracting parties under special protocols, it would also appear problematic that the Agreement establishing the World Trade Organization (WTO) provides that all protocols of accession will form part of "GATT 1994". This would imply that any special condition included in their protocols of accession to "GATT 1947" would take precedence over the provisions of the Uruguay Round Agreement.

44. Active international support is therefore required to facilitate the full integration of the economies in transition into the international trading system. The most effective forms of such international support would include: (a) recognition of economies in transition as normal trading partners, i.e. conduct of trade

relations with them on the basis of unconditional MFN treatment and elimination of all residual elements of past discriminatory trade regimes applied against these countries; (b) encouragement of negotiation or renegotiation of their GATT membership on the basis of the Uruguay Round results; and (c) further improvement of market access for their export goods and services as an essential factor in the transition to a market economy. Particular attention should be paid to improving, in a non-discriminatory manner, trading opportunities for these countries in goods and services sectors where they have developed comparative advantage and export capacities. UNCTAD is providing technical support to certain economies in transition, as in the case of other countries, to enhance their benefits from GSP and to strengthen their negotiating capacities, so as to effectively participate in the post-Uruguay-Round international trading system.

Chapter II

TRADE AMONGST ECONOMIES IN TRANSITION: PROBLEMS AND OPPORTUNITIES

45. The downward slide in trade amongst economies in transition, which began in 1989, has turned into a real collapse since 1990 when the former CMEA decided to turn to convertible currency payments in mutual trade. Shortly thereafter, this organization ceased to exist. Mutual exports amongst Central and Eastern European countries and the former Soviet Union about halved between 1988 and 1992. According to ECE estimates, this trend continued in the first half of 1993 with a further decrease of 12 per cent.[35]

46. Exports of Visegrad countries to Central and Eastern Europe, including the former Soviet Union, declined by almost US$10 billion, or about 57 per cent, over the period 1988-1992. Intra-trade amongst the Visegrad countries was no exception, as its value has diminished continuously, by a total of 44 per cent, over the past five years. As a result, the share of mutual trade in total exports dropped from 10.1 to 5.8 per cent. Due to their relative importance, a similar decline in exports to the Soviet Union by about 58 per cent had an even larger impact on the overall exports of Visegrad countries. The former Soviet Union's share fell from 22.6 per cent in 1988 to 12.1 per cent in 1992 (see annex table 2).

47. Trade of South-East European countries with Central and Eastern European countries in transition has contracted to very low levels: Romanian exports to these countries, as well as Bulgarian exports to Visegrad countries and Romania, have fallen by three-quarters over the past five years.

48. Following the dissolution of the former Soviet Union, the CIS States face a similar foreign trade contraction: in 1992 their mutual trade fell by about one-third, and in 1993 by another 30 per cent. This contraction had particularly serious effects on their economies, as CIS States had previously conducted the overwhelming share of their trade within the former Soviet Union: in 1991 imports and exports within the former Soviet Union accounted for between 80 and 99 per cent of total imports and exports worldwide for the 10 smaller CIS member States and between 68 and 84 per cent for the Russian Federation and the Ukraine (see annex table 5). These tight interlinkages between CIS countries demonstrate that their economies and their enterprises cannot afford to be simply cut off abruptly from their main markets by new frontiers, trade barriers and monetary obstacles. Transition, combined with the break-up, brought about the disruption of many traditional trading channels and industrial linkages for supplies of industrial materials and components. Suppliers cannot expect to find new

markets in other regions rapidly. Mutual supplies of energy and basic commodities have declined drastically as well, partially because of unresolved problems due to non-market-conforming prices. The newly emerging private small and medium-scale industries need to be assisted in starting to explore the many opportunities which still exist within CIS for industrial cooperation and mutual trade.

49. A similar situation exists in the Baltic States: until 1991 their trade was almost exclusively conducted within the former Soviet Union, which accounted for 95-97 per cent of their exports and 85-90 per cent of their imports. This pattern is undergoing rapid change, as trade with developed countries, and in particular Western Europe, is rapidly expanding: for example, in 1992 one-quarter of Lithuanian exports (which account for half of those of the Baltic States) were shipped to developed countries, 6 per cent to CEFTA and 6 per cent to the Baltic States.

50. A certain decline in mutual trade during the transition process and after the break-up of countries into separate new States was certainly unavoidable. The adjustment to competitive markets and world market prices was necessary and economically sound, as is the extension of international specialization to further regions and world markets. To the extent that specialization amongst the countries of Eastern and Central Europe had been planned under the former CMEA with little consideration for international market conditions and national factor endowments, such trade contraction is likely to persist.

51. The disruption of mutual trade was a major cause for the sharp deterioration of all economies in transition. Since 1990 industrial output has been contracting at a rate of between 3 and 25 per cent annually in most Visegrad countries and South-East Europe. In 1992 the decline reached 18 per cent in CIS and between 35 and 51 per cent in the Baltic States. This declining trend continued in 1993. Only Poland succeeded in reverting to growth in industrial output as from 1992, and Hungary showed signs of recovery in 1993.[36]

52. Break-up and transition combined to bring about this serious contraction of mutual trade, industrial relations and production. Various factors were at work. A major cause was the inadequacy of a large proportion of the supply capacities in the various economies in transition. There is in effect a large backlog in respect of the rationalization and modernization of production, the upgrading of technological and managerial capabilities and the adaptation of the quality, standards and prices of products. The limited financial capacities of the enterprise sector, the general shortage of investment financing and the slow response of foreign investors are slowing down progress. Furthermore, the enterprise sector of many economies in transition is largely being left to its own devices, as new national support policies are only emerging.

53. A major shake-up for trade within the former Soviet Union came from the monetary sphere, with the replacement of the rouble by national currencies. During the establishment of fully-functioning Central Banks and of monetary and foreign exchange management in CIS and Baltic States, substantial uncertainty, high inflation and heavily fluctuating mutual exchange rates seriously affected mutual trade.[37] Furthermore, hard currency receipts are very attractive to exporters, and instability and inflation are an incentive for transfers abroad.

54. On the other hand, export credits offered by foreign competitors are a major determinant for import sourcing at the present stage for economies in transition. In most of them, such facilities are not available either from commercial banks or from governmental institutions for medium- and longer-term maturities. Where export credits and export credit guarantee schemes exist at all, they usually do not cover exports to Central and Eastern European countries, or imply high-risk premiums. Where Central and Eastern European countries could export machinery, tractors, vehicles and other commodities usually traded on medium- to long-term credit, it is indispensable to establish or extend the scope of financing and insurance facilities to be able to cope with international competition. The lack of elaborate banking services and mutual links may also cause considerable delays and uncertainty for inter-country payments for trade and service transactions:[38] support for mutual cooperation by banks and the expansion and improvement of clearing mechanisms for settlement of commercial transactions has acquired some urgency. The new trading partners within Central and Eastern Europe are largely unknown, and it may be difficult to obtain reliable information and guarantees concerning their financial capacity and solvency. For these reasons, there is a strong need to improve the availability of guarantees for importers in transition economies that would be acceptable to exporters from all regions. Technical cooperation in the form of intensive training programmes, as well as the admission of mature Western banks to domestic financial markets, can make an essential contribution to upgrading the banking services for trade-related payments, financing and insurance.

55. Furthermore, new trade policy barriers have recently been erected amongst various economies in transition as they build up their national customs and apply certain quantitative restrictions to trade with other independent Central and Eastern European countries. While trade is being liberalized within integration arrangements with Western European countries, increasing MFN rates render competition more difficult for exporters from other Central and Eastern European countries in transition. In some cases, new tariffs are imposed on imports from Baltic States at higher-than-MFN rates. While in general mutual trade amongst Central and Eastern European countries in transition is now largely taking

place on the basis of convertible currencies, trade in strategic commodities and in particular fuels is still largely based on barter in CIS States' mutual trade and in their trade with Baltic States. Preferential prices for such strategic goods are progressively being aligned with world market prices. On the other hand, the application of export quotas to mutual trade in major commodities is seriously hampering previous industrial linkages dependent on regional sources of supplies of raw materials, metals and energy.

56. Major attempts have been launched by Central European countries, the Baltic States and CIS to revive their trade, payments and economic cooperation through the establishment of integration arrangements. The Czech Republic, Hungary, Poland and Slovakia have established the Central European Free Trade Area (CEFTA): member countries agreed gradually to reduce their tariffs and other import restrictions on specific products at varying speeds.[39] The Baltic Free Trade Agreement between Estonia, Latvia and Lithuania has a similar but somewhat more limited scope.[40] Other initiatives aimed at promoting regional economic cooperation involve both economies in transition and developing countries, as in the case of the Economic Cooperation Organization or the Black Sea Area Cooperation arrangement.

57. The establishment of a new framework for trade and enterprise cooperation within CIS is proceeding along various avenues: (a) the new CIS Economic Union was proclaimed by the Declaration of the Heads of CIS States in September 1993. It is now on the legal drawing board and should be finalized soon. This framework is to progress by stages, starting from a free trade area and moving gradually to a customs union, a currency union and full economic union; (b) the new CIS economic framework (now eclectic and legally vague) should enable a progressive shift from bilateral to predominantly multilateral instruments for its implementation. Some 80 multilateral economic agreements have already been concluded by now; (c) several initiatives have been taken at the enterprise level to form "FSU transnational corporations" able to become internationally competitive, inter alia through privatization, mergers or acquisitions; (d) furthermore, on 1 January 1994 a new agreement entered into force to eliminate all customs tariffs on intra-CIS trade.

58. In addition, business circles took a number of initiatives beyond governmental measures to reintegrate mutual trade and investment, set up joint ventures or engage in large-scale joint projects for exploiting oil and gas resources. In view of the insufficient functioning of intergovernmental clearing mechanisms, 35 commercial banks set up their own clearing house for settlements throughout CIS.

59. However, CIS agreements reached thus far have only the character of framework agreements, which need to be complemented by detailed plans and timetables for implementation before they will become operational. Second, most CIS agreements have still to undergo ratification processes in the various member countries, which takes a considerable time. Third, intergovernmental agreements are unlikely to be sufficient by themselves to relaunch mutual trade and enterprise cooperation. There is a pronounced need to strengthen national and joint action at the micro-economic level and to assist the large number of newly emerging enterprises, and in particular the SME sector, to explore the still existing opportunities for trade and industrial cooperation within CIS. Fourth, the new CIS institutions are only in the initial phases of organizing themselves. The CIS secretariat, the CIS Bank, etc. need to be considerably strengthened to enable them to provide substantive support, to accelerate implementation, and to take new initiatives to advance mutual cooperation through pragmatic, flexible and rapidly implementable measures.

60. Technical assistance by integration groupings with specialized experience can assist in rendering integration within CIS, CEFTA, etc., more effective. Support by the European Union already plays an important role in the development of CEFTA. International organizations, including UNCTAD, the United Nations regional commissions and development banks also provide technical support for regional integration.

Chapter III

TRADE AND ECONOMIC COOPERATION BETWEEN DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION

A. Recent trends and the potential for trade expansion

61. The transition towards market economies, the transfer of autonomy of decision-making to enterprises and the major liberalization and deregulation of foreign trade, investment and capital transactions should in the near future create a new environment for trade and investment relations between developing countries and economies in transition.

62. In the new setting, CIS countries remain the main trading partners amongst the economies in transition for the developing countries, with a strong concentration on the Russian Federation, followed by the Ukraine and Kazakhstan. Other Central Asian republics are comparatively small trading partners but have relatively intensive trading relations with developing countries. On average, CIS represented about 1.2 per cent of developing countries' global exports in 1992. The Visegrad countries accounted for another 0.4 per cent of their exports, South-East European countries 0.2 per cent, and the Baltic States 0.1 per cent. However, past trade and economic relations had been concentrated on a relatively small number of developing trading partners: for them, trade with economies in transition is therefore of high importance with regard to exports (see annex table 6), import supplies and investment.

63. Many developing countries have raised concerns about the serious contraction of their trade with major economies in transition. Between 1990 and 1992, developing countries' exports to CIS shrank by 18 per cent, with a further decrease of more than one-third during the first half of 1993. Some trading relations had been on the decline since earlier in the 1980s: this was the case in particular for several African countries and major traditional Latin American suppliers, including Argentina and Brazil. Trade of some others, such as India, Egypt and the Syrian Arab Republic, suffered a serious in 1989/1990. Trade of the former developing country members of CMEA (Cuba, Mongolia, Viet Nam), but also of the Democratic People's Republic of Korea and others, was particularly affected (see annex tables 11 and 12).

64. Only a few developing countries have succeeded in significantly expanding their exports to CIS in recent years, notably China, Taiwan Province of China, the Republic of Korea, Singapore and the United Arab Emirates. Their export increases to CIS and Visegrad countries, mainly to Poland, have been

concentrated in particular on consumer electronics and other consumer goods.[41] But not all dynamic Asian exporters have been successful on these markets. Furthermore, after initial growth, exports have levelled off again recently in the cases of Malaysia and Thailand.

65. Patterns of CIS commodity exports to the traditional developing country partners have remained, as in the past, heavily concentrated on a few commodities, as well as metals and other products of basic industries. This was also the case of most exports from developing countries, as only a few countries, such as India and the former Yugoslavia, had more diversified exports, including a range of industrial products (see annex tables 7 and 8).

66. The reorientation of Visegrad countries' trade to Western Europe shows the potential dynamism of market-based trade. Exports from industrialized countries to the Visegrad countries' markets almost doubled between 1989 and 1992, rising from US$15 billion to $28 billion, and replaced a large portion of the trade previously conducted with CMEA member countries. In contrast, developing country exports to these destinations further declined over the same period by about 8 per cent. A notable exception was the rapid expansion of Polish imports from these countries over the past two years. Some diversification and geographical restructuring of developing countries' trade is taking place in Visegrad markets, with some increase in imports of fuel from Saudi Arabia, the Islamic Republic of Iran, etc., and of consumer electronics and other manufactures from a few new developing partners in South-East Asia, such as Thailand, the Republic of Korea, Singapore, and Taiwan Province of China.

67. Thus the transition process, while having seriously affected traditional partners, has not yet sufficiently advanced to inject widespread and sustained dynamism into new market-based trade relations with a larger number of developing countries. There may be various reason for this, as in many cases the basic trade support instruments are lacking on both sides, in contrast to trade with developed countries.

68. The abandonment of the old system based on bilateral trade has not only led to the elimination of politically motivated trade which was not in accordance with market criteria and prices or possibilities for international specialization based on comparative advantage, but has also affected economically justified trade as a result of inappropriate policies and instruments:

(a) Trade financing is a major factor for competition with developed country competitors. However, few developing countries have the capacity in terms of export financing and export risk guarantees required to compete for the new market-based trading opportunities in economies in transition. Even for basic commodities, for financial reasons European intermediaries frequently become involved in what were previously direct trading relations with Central and Eastern European countries;

(b) As in the case of intra-trade in Central and Eastern European countries in transition, the gaps prevailing in the banking system, the lack of direct payments and financing relations, as well as difficulties in obtaining reliable guarantees regarding CEECT importers give rise to delays and risks of payments defaults discouraging mutual trade expansion;

(c) Modernization and rationalization of production capacity and the upgrading and adjustment of products to competitive market requirements have not yet reached the stage of bringing about a decisive change in the commodity trading patterns and international specialization of most economies in transition. The lack of long-term credits and FDI financing, as well as of support for outward joint ventures, is likely to hamper such exports as agricultural machinery, heavy electrical equipment and commercial vehicles, though they are of substantial import interest to developing countries;

(d) As trade operators have changed, it would appear necessary to smooth these changes by contact services, trade information and logistical support to bring the unknown partners, including many new small and medium-scale enterprises, together;

(e) The large outstanding debt of certain developing countries vis-a-vis Russia puts a brake on trade expansion.

69. Bilateral agreements and barter trade still play a role in mutual trading relations, in particular for commodities and consumer goods. Payments relating to trade between CIS countries and certain developing countries, such as Cuba, Viet Nam, Mongolia, the Democratic People's Republic of Korea, Egypt, India and Bangladesh, are still settled under clearing arrangements.

70. As transformation progresses, its success ought to create, however, a substantial new potential for market-based trade in the medium and longer term for all suppliers, including the developing countries. An attempt was made to evaluate the potential magnitude of such trading possibilities with developing countries, working on the assumption that specialization of production and trading patterns will lead gradually to market-driven levels of international trade similar to those reached by developed market economies.[42] For that purpose, imports of Central and Eastern European countries in transition from the developing countries were compared first with those of European Community. States with similar levels of 1988 per capita GNP, adjusted for population size, and secondly with those of the EC as a whole, again adjusted

for population size. The first of these calculations shows that Central European imports could rise by a factor of five. This means that if these countries had been importing from developing countries at a level similar to that of the comparable EC countries, they would have been importing a total of five times as much from their 20 largest developing country suppliers. According to similar calculations, the former Soviet Union's imports from the developing countries in 1991 would have been some four times greater. In both cases, most developing countries, and even the larger ones with special links with the former CMEA, such as India and Egypt, would have done better under a free market (see annex table 9).

71. The second set of estimates indicates the change in the volume of trade with the developing countries that might be expected in the longer run when the economies in transition reach the average 1988 EC per capita GNP. It suggests that imports from the 20 largest developing country exporters would be some eight times the pre-transition volume. All the individual exporters would gain (though there may be some question about Afghanistan, Cuba, the Democratic People's Republic of Korea and Viet Nam, for which data are not available) (see annex table 10). These results should be taken only as indicative of the large potential contribution that countries in transition are likely to make to developing countries' trade expansion as they succeed in their reform process.

72. The expansion of opportunities will not be a one-way process. The new export markets for the developing countries in the countries of Central and Eastern Europe will be matched by growing markets for the exports of the latter. The countries of East and South Asia are developing particularly rapidly and offer great opportunities.

73. In the past, Central and Eastern European countries were also engaged in close investment and technological cooperation with certain developing countries. This frequently formed part of the overall contractual framework for economic cooperation and included important financial aid and technical assistance. However, due to financial constraints, the ability of the economies in transition to engage in development assistance will be somewhat limited for some time.

74. In recent years, investment and technological cooperation has also started in the opposite direction. Developing countries which have the entrepreneurial, financial and governmental back-up facilities have started to invest and engage in joint ventures in economies in transition: this has increasingly been the case for China, India and the Republic of Korea, but has occasionally also involved investors from other developing countries such as Malaysia, Thailand and Brazil. Such investment can offer substantial know-how relating to the application and adaptation of

modern technologies in the manufacturing process. It could eventually become important in such sectors as telecommunications, consumer electronics, robotics, computer-controlled garment-making machinery or software.

B. Trade and investment policies

75. The fact that economies in transition, as well as many developing countries, have been the most dynamic forces of liberalization of foreign trade and investment should ultimately be reflected in growing mutual relations as well.

76. Furthermore, the Visegrad countries, Bulgaria and the Russian Federation have adopted or confirmed their GSP schemes in favour of developing countries. Others, such as Belarus and the Ukraine, have indicated their intention to introduce GSP schemes. The schemes are generally liberal, as they cover in principle all types of products and grant duty-free access to least developed countries. The preference margin varies: it is 30 per cent in Poland, with zero tariffs on tropical products; the Czech republic levies GSP tariffs on eligible imports at 25 per cent of MFN rates, while most tropical products are admitted duty-free. Hungary and Bulgaria have a three-column tariff schedule defining GSP rates for each heading. The scheme of the Russian Federation provides for GSP tariffs at 50 per cent of MFN rates.

77. Certain developing countries, however, have expressed concern that recent increases in MFN rates by certain economies in transition have led to increased tariffs on developing countries' imports. At the same time, developing countries' enterprises face increasing difficulties in competing with firms from Western European countries, for whom import protection is being progressively reduced under the Europe Agreements and the Free Trade Agreements with EFTA countries. This creates a price differential to their disadvantage. All efforts should therefore be made by economies in transition to stabilize and improve GSP treatment in favour of developing country suppliers. The remaining industrialized CIS States should be encouraged to introduce national GSP schemes.

78. Central and Eastern European States have done much to establish a welcoming and attractive environment for foreign investors. However, there is still much to be done in simplifying bureaucratic procedures and clarifying the regulations, establishing property rights, defining environmental obligations, and indemnifying against nationalization or confiscation, as well as taking into account specific requirements of smaller and medium-sized foreign investors, including those from developing countries. The newly industrialized countries, particularly those in South-East Asia, are likely to take advantage of new opportunities for FDI and joint ventures in CIS. However, there have been only a few

cases of bilateral investment cooperation and guarantee agreements, which are important for the security of investments, being concluded between economies in transition and developing countries. It will be necessary to enlarge the network of such bilateral investment agreements and double taxation agreements, to intensify investment financing and guarantees for home enterprises, and to establish investment promotion offices and investment advisory services at both ends.

C. International support for cooperation in trade and investment

79. Although substantial technical assistance is extended by multilateral organizations and bilateral donors to economies in transition in such areas as foreign trade and investment legislation, assistance focusing specifically on support for trade and investment cooperation between economies in transition and developing countries has remained scarce. However, an important step was recently taken by the United Nations General Assembly, which called upon the international community to consider assisting the developing countries whose economies have been most affected by the changes in their economic relations with the economies in transition in order to adapt to those changes.[43] UNCTAD for its part can make a contribution in the field of trade and investment and has started to provide technical cooperation in the form of training, including the organization of a workshop for trade representatives and economic counsellors of developing countries accredited to CIS States. Preparations are under way for business weeks in developing countries during which the business communities from both sides can discuss possibilities for initiating or expanding trade. Substantial further needs exist, and various United Nations bodies, particularly UNCTAD, as well as regional economic commissions and ITC, could make major contributions through their regular analytical and substantive work, as well as their technical cooperation activities, to expansion of mutual trade and investment.

80. Bilateral and international support could in particular foster a more favourable policy environment for trade and investment cooperation between economies in transition and developing countries.

81. International and bilateral financial support could help to bridge gaps in trade financing[44] and allow the exploitation of the potential for investment and technological cooperation between such countries.[45] Untying of bilateral and regional credits should be pursued whenever feasible in favour of procurement from developing countries (including those belonging to CIS). Second, as long-term financing and equity are scarce in most cases at both ends, the feasibility of an international co-financing scheme should be explored to prepare, promote and finance the investment and take-

off phase of FDI and joint venture projects between such countries. Finance would be concessional and additional to finance provided by the directly participating enterprises and the governments of the countries concerned. Experience with the European Union's Scheme of International Investment Partners, Finnfund and Project Preparation Facilities of the World Bank and other regional development funds, as well as the operations of EBRD, could be useful for such an evaluation. Third, international or bilateral support could assist in relaunching and exploiting the high existing potential for technological cooperation. Accordingly, the feasibility should be explored of extending such programmes as PHARE and TACIS to cover technical cooperation projects between economies in transition concerned and developing countries. Developed countries should also consider extending procurement and participation of experts from developing countries under such schemes.

82. The Cartagena Commitment has already set out UNCTAD's role in this area: the Trade and Development Board should periodically assess the process of transition in the field of trade, including support to transition, trade liberalization and trade with developing countries; UNCTAD should identify the opportunities resulting from the above developments for the mutual benefit of developing countries and individual countries of Central and Eastern Europe; and technical assistance is to be provided with a view to helping developing countries derive the maximum benefit in terms of expansion of trade and reinforcement of economic cooperation with individual countries of Central and Eastern Europe. Furthermore, in the context of the forthcoming analysis and assessment of the outcome of the Uruguay Round, the Board should examine, inter alia, the problems and opportunities which the economies in transition in Central and Eastern Europe face in increasing their participation in international trade in goods and services. UNCTAD is ready to contribute, within its mandate, through research, analysis and technical cooperation to complement activities of other international organizations.

NOTES

1. The Commonwealth of Independent States (CIS), comprises Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. The Baltic States include Estonia, Latvia and Lithuania; the Visegrad countries include the Czech Republic, Hungary, Poland and the Slovak Republic; South East European countries include Albania, Bulgaria, and Romania.

2. See, for example, UNCTAD, "Trade policy reforms in developing countries and the international support required", TD/B/39(2)/3 (1993), and UNCTAD, "Measures and incentives for enhancing the competitiveness of sectors with export potential in developing countries: Evidence and lessons of experience", UNCTAD/ITP/90 (1992).

3. These issues were discussed in depth by the Trade and Development Board at its fortieth session. The Board proposed measures to improve interaction between larger economic spaces and the multilateral trading systems; stressed the special responsibility of integration groupings with regard to their implication for weaker trading partners, particularly developing countries, and encouraged members of groups to intensify support, technical cooperation and investment cooperation to such countries. (See conclusion 408 (XL) adopted by the Trade and Development Board at the first part of its fortieth session, TD/B/40(11)/14, Volume 1.) For a detailed analysis, see "Evolution and consequences of economic spaces and regional integration processes, TD/B/40(1)/7, UNCTAD, 1993.

4. See, "UNCTAD's contribution within its mandate to sustainable development: trade and environment. Trends in the field of trade and environment in the framework of international cooperation", TD/B/40(1)/6.

5. See "Trade Policy reforms ...", and "Measures and Incentives ..."

6. See, _inter alia_, "Foreign direct investment in Africa", E/C.10/1994/6, and the report of the Expert Group on Policy options for attracting FDI to Africa (forthcoming). This is one of the issues under consideration by the Ad Hoc Working Group on the Interrelationship between Investment and Technology Transfer.

7. See "Asian model attests to value of openness and minimal policy-induced distortions", _IMF Survey_, volume 22 (November 1993).

8. Trade and Development Board agreed conclusion 401 (XXXIX), adopted at the Board's thirty-ninth session (first part), March 1993, TD/B/39(2)/26.

9. See "Trade policy reforms ...", Chapter 2E.

10. See the documentation submitted by the Secretary-General of UNCTAD to the twentieth session of the Commission on Transnational Corporations on "Trends in foreign direct investment" (E/C.10/1994/6) and "FDI to least developed and other developing countries outside Africa" (E/C.10/1994/7).

11. For example, tariffication of national import quotas led to extremely high MFN rates for imports exceeding a special fixed tariff quota; national import quotas for some fishing products were temporarily extended to the Community as a whole. The common market organization for fruit and vegetables, which gave rise recently to some market access problems and countervailing charges, was extended to tropical fruits. Furthermore, the European Economic Area liberalized mutual trade in a number of processed tropical products, which remained subject to relatively high duties for imports from developing countries.

12. See, inter alia, "Collapse and transition in Central and Eastern Europe", chapter V of the Trade and Development Report 1993, UNCTAD/TDR/13, Geneva.

13. See section 2 below regarding relations with GATT, as well as chapter III on CIS.

14. See "Evolution and consequences of economic spaces and regional integration", TD/B/40(1)/7.

15. See section 3 below regarding integration into the international trading system and chapter II on CIS.

16. For more details, see Economic Bulletin for Europe, volume 45 (1993), p.72.

17. See UNCTAD Handbook of International Trade and Development Statistics 1992, Part 7.3, special tables on CIS, Baltic countries and Georgia (former USSR), 1993 (E/F.93.II.D.9).

18. Examples of products where such increased competition is likely to arise within the context of Europe Agreements can be found in "Evolution and consequences of economic spaces and regional integration processes", TD/B/40/(1)/7, paragraphs 53 and 54. See also Economic Review, EBRD, London, September 1993.

19. A more comprehensive review of the literature on prospective competitive exports from Central and Eastern European countries in transition contained in M. Davenport, "Fostering integration of the countries in transition in Central and Eastern Europe into the world economy and the implications for the developing countries", UNCTAD/ITD/7. See also: Economic Review, EBRD, London, September 1993.

20. See "Banking Reform", in "Current Economic Issues," EBRD Review, July 1993.

21. M. Davenport, op.cit.

22. There is some risk that bilateral and multilateral ODA for economies in transition could compete with ODA for developing countries. While actual disbursements of ODA to economies in transition remain far behind original pledges, there may be shifts of priorities in certain aid programmes, in view of the scarcity of budgetary resources. The General Assembly therefore, in its resolution 47/175, urged the developed countries and multilateral financial institutions to continue to ensure that the resources allocated to the economies in transition do not reduce or divert official development assistance allocated to the developing countries.

23. See CEECT Register of the OECD, which provides a data base on advisory services, technical assistance projects, training and research undertaken by bilateral and multilateral donors in favour of Central and Eastern European economies in transition, including CIS and Baltic States in a large range of areas such as: trade, investment and private sector participation; the financial services sector; state enterprise restructuring, privatization, small and medium enterprises development; management capacity; conversion of defence-related industry and utilization of scientific and technological resources; as well as a large number of other sectors, including transport, telecommunication, energy, environment, food, health, housing, social safety nets.

24. See "Strengthening the negotiating capacity of developing countries in their dealing with transnational corporations", Report of the Secretary-General of UNCTAD on technical cooperation activities (forthcoming).

25. Source: World Bank, World Debt Tables, 1992/1993.

26. See East West Investment News, No. 2, Summer 1993, United Nations Economic Commission for Europe.

27. Daily Bulletin of the United States Mission in Geneva, 18 November 1993, p.8.

28. Several of them do not even enjoy MFN treatment in the United States, in the absence of bilateral trade agreements with that country.

29. By virtue of Council Regulation (EEC) No. 3420/83 on import arrangements for products originating in state trading countries, not liberalized at the Community level, OJ No. L 346, 8 December 1983 (and numerous amendments to that regulation from 1983 to 1993).

30. See "Export Access to Western Markets" in "Current economic Issues", EBRD Economic Review, July 1993.

31. For example, the selective safeguard clause in the recent Interim Agreements between the European Community and Central and Eastern European countries, which are parts of more comprehensive "Europe Agreements" (Official Journal of the European Communities, L 114-116, Volume 35, 30 April 1992). "Market disruption safeguards" are contained in the Agreements on Trade Relations between the United States and former USSR republics (Russian Federation, Kazakhstan, Ukraine, etc.)

32. For example, section 406 of the United States Act of 1974 sets special provisions for investigation of "market disruption from non-market economies".

33. These provisions are based on Article 15 of the GATT Subsidies Code as well as Article 2:7 of the GATT Anti-Dumping Code, both drawn from the interpretative note to Article VI of GATT; see also Council Regulation (EEC) No. 2423/88 of 11 July 1988, O.J. No. L 209, page 5 of Article 2 and page 3 of Article 3.

34. Text of GATT, Annex I, Notes and Supplementary Provisions, Article VI, paragraph 1:2, Geneva, July 1986.

35. Economic Bulletin for Europe, vol. 45 (1993), table 3.1.1.

36. Ibid, table 2.2.1.

37. See "Banking reform", in "Current Economic Issues", EBRD Review, July 1993.

38. Settlement of balances between commercial banks across CIS borders can take months. Many suppliers are, at present, unwilling to ship goods until payment has been credited to their accounts. In fact, the "pre-payment system" currently in force in the Russian Federation requires the inter-account transfer to precede and delivery of goods. The methods of processing, clearing and settling business payments have to be modernized on an urgent basis to facilitate trade expansion. See Russian

Economic Reform: Crossing the Threshold of Structural Change, World Bank Country Study, Washington, D.C., 1992;
C. Michalopoulos and D. Tarr, Trade and Payment Arrangements for States of the Former USSR, Studies of Economies in Transition, paper No. 2, World Bank, Washington, D.C., 1992.

39. See "Evolution and consequences of economic spaces and regional integration processes", TD/B/40(1)/7, chapter II.C.

40. See "Regional initiatives " and "Trade and payments between republics of the former Soviet Union", in EBRD Annual Review, 1992.

41. Economic Integration, OECD Economies, Dynamic Asian Economies and Central Eastern European Countries, OECD, Paris, 1993.

42. See M. Davenport, op.cit.

43. General Assembly resolution 47/175.

44. See inter alia, the background documentation for the forty-seventh and forty-eighth session of the General Assembly on this topic: "Impact of the evolution of East-West relations on global growth and development", A/47/403 and "Development and international economic cooperation: Impact of the recent evolution of the economies in transition on the world economy", chapter III, Report of the Secretary-General, A/48/331, September 1993.

45. In its resolution on "Changes in East-West and North-South regulations" A/30/392/91 of 14 May 1992, the European Parliament called for a joint European East-West-South Community initiative within a wide-ranging Community cooperation programme. The Commission, the Council and the countries of Central and Eastern Europe should, inter alia, consider strategies for coordinated cooperation in developing countries; ties frequently attached to development aid should be reduced; the Community should promote an overall trade policy, which takes account of the interests of developing countries and the countries of Eastern Europe; and the Commission should develop initiatives and grant the necessary financial assistance to bring about trade flows between the Eastern European countries and the developing countries. It will be of interest to see the follow-up to this initiative of the European Parliament (see Official Journal of the European Communities, No. C 150 of 16 June 1992).